85-519

No. ———

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

APPENDIX

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 84-5053
No. 84-5058
No. 84-5059

Dr. Roger E. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann, and Dr. William C. Randall,

Appellees,

v.

B. J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation; Property Development and Research Company, a Minnesota corporation and 2361 Building Corporation,

Appellants.

Appeals from the United States District Court for the District of Minnesota

Submitted: January 17, 1985 Filed: July 16, 1985

Before LAY, Chief Judge, and HEANEY, BRIGHT, ROSS, McMILLIAN, ARNOLD, JOHN R. GIBSON, FAGG, and BOWMAN, Circuit Judges.

PER CURIAM.

This en banc hearing arises from a retrial on the issue of damages ordered by this Court in *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982) (*Austin I*). In *Austin I*, we affirmed the jury's verdict that Loftsgaarden and three of his closely-held corporations (hereinafter Loftsgaarden) violated state and federal securities laws, but held that the district court erred in ruling that the plaintiff-investors' rescissionary damages could not be reduced by the "tax shelter"[1] benefits they received as a result of their investments. Thereafter, we denied plaintiffs' petition for rehearing or rehearing en banc.

On remand, the district court deducted plaintiffs' tax benefits from their damage awards and both sides appeal. After oral argument before a panel of this Court, the panel issued an order setting two issues for en banc consideration: First, whether *Austin I* should be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment that was structured and marketed as a tax shelter; and second, assuming that *Austin I* was properly decided, what is the proper measure of plaintiffs' rescissionary damages?

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[1]In *Austin I*, we defined "tax shelters" as investments which allow the investor

> to offset certain "artificial losses" (that is noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from those investments but also against the [investor's] other income, usually from his regular business or professional activity.

675 F.2d at 183 (citing Staff of Joint Comm. on Internal Revenue Taxation, 94th Cong., 1st Sess., *Overview of Tax Shelters* 1 (Comm. Print 1975)).

FACTS

The facts in this case are set forth in detail in *Austin I*, 675 F.2d at 173-76. We briefly review them here.

Plaintiffs Austin, Anderson, Neumann and Randall, invested over $152,000 in Alotel Associates (hereinafter Associates), a limited partnership organized by defendant B. J. Loftsgaarden to help finance the building and operation of a Ramada Inn in Rochester, Minnesota. Loftsgaarden's offering memorandum claimed that purchasers of the limited partnership interests would receive substantial tax benefits during the first three years of their investments and thereafter would share in the hotel's projected profits.

The Rochester Ramada opened several months behind schedule in 1974 at a construction cost substantially in excess of that projected. Thereafter, the hotel incurred significant operating losses and Loftsgaarden requested the limited partners to extend to Associates several large loans to prevent insolvency. The limited partners hired a lawyer and an accountant to investigate Loftsgaarden's stewardship of the project, which revealed that Loftsgaarden had knowingly committed several frauds on the limited partners. Although Loftsgaarden resigned as general partner and the limited partners made additional loans,[2] the partnership ultimately defaulted on its obligations and the hotel was foreclosed upon.

The four plaintiffs[3] then filed this securities fraud action

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[2]The jury found that these advances were not induced by any misrepresentations by Loftsgaarden and thus the plaintiffs could not recover them.

[3]The numerous other limited partners were initially parties to this action but subsequently dropped their claims.

against Loftsgaarden. The jury found that Loftsgaarden had violated "section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. 240.10b-5; the antifraud provision of the Minnesota Securities Act, Minn. Stat. §§ 80A.01, *et seq.*, 80A.23; and [had committed] common law fraud. The jury rendered an advisory verdict—in which the district court concurred—that defendants were liable for violating § 12 (2) of the Securities Act of 1933. 15 U.S.C. § 77*l*(2)." *Austin I*, 675 F.2d at 172 (footnotes omitted.) The court applied a rescissionary measure of damages in the amount of the consideration each plaintiff paid for his limited partnership unit or units, prejudgment interest from the date of purchase, and attorneys' fees for plaintiffs Randall and Neumann for a total judgment of $273,720.

We affirmed the findings of liability, but vacated the award of damages and remanded to the district court, stating "the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I*, 675 F.2d at 181.

On remand, the district court awarded to plaintiffs damages in the amount of their consideration paid, with eight percent interest thereon, less tax benefits received, for a total amount as follows. Anderson, $35,172; Austin, $31,277; Neumann, $39,371; and Randall, $31,569. It also granted attorneys' fees under Minn. Stat. § 80A 23, subd. 2 as follows: Anderson, $0; Austin, $0; Neumann, $29,000; and Randall, $20,000. In addition, the court granted costs of $5,321.83 to Austin, Anderson and

Neumann and $2,955.49 to Randall. We now consider the two issues raised before the Court en banc.

DISCUSSION

I. *Should Austin I be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment structured and marketed as a "tax shelter"?*

The starting point for our analysis is that the petition for rehearing or rehearing en banc in *Austin I* was denied, 675 F.2d at 168, and that, accordingly, its holdings are now law of the case. As we stated in *Otten v. Stonewall Ins. Co.*, 538 F.2d 210 (8th Cir. 1978):

> Law of the case principles have been stated with clarity and consistency in this court over a long period of time. "This court has repeatedly held that the decision on former appeal is the 'law of the case' on a question presented in that former appeal, unless the evidence introduced at the subsequent trial is substantially different from that considered on the first appeal, and must be followed in all subsequent proceedings in such case in both district and appellate courts unless that decision is clearly erroneous and works manifest injustice. * * * While this rule of practice is not a limit of power, it is nevertheless a salutary one, and should be departed from only after careful consideration of situations arising in specific cases."

Id. at 212 (citations omitted).

The appellees contend that the damages holding in *Austin I* is "clearly erroneous" and works a "manifest injustice" and thus should be reversed. After a careful review

of *Austin I*, the relevant cases, the arguments of the parties and the Tax Division of the Justice Department and the Securities and Exchange Commission, appearing as *amicus curiae*, we abide by our previous decision. In doing so, we note that since our opinion in *Austin I*, the United States Court of Appeals for the Second Circuit has substantially adopted the views that we expressed in that case. *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984).[4]

Our decision in *Austin I* was based on the principle that: "[D]amages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party." *Austin I*, 675 F.2d at 180 (citation omitted). We noted that for this reason, the courts typically used the out-of-pocket measure of damages,[5] but that where a rescilssionary measure of damages is applied, the "actual damages principle requires that a rescissionary * * * award be reduced by any value received as a result of the fraudulent transaction." *Austin I*, 675 F.2d at 181 (citation omitted). We held that this principle applied not only to the 1933 Act claims and the claim under Minn. Stat. § 80A.23(2),[6] (both of which explicitly

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[4]*But cf. Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) (applying different rule in case of actual rescission).

[5]The parties are in dispute over whether the out-of-pocket measure of damages would provide recovery similar to that approved here. *See Salcer*, 744 F.2d at 940 n.5, Brief of SEC at 22-23. We need not address this issue, however. *Austin I* limited its holding to tax shelter cases where a recissionary measure of damages is applied. 675 F.2d at 183.

[6]In *Hayden v. MacDonald*, 742 F.2d 423 (8th Cir. 1984), plaintiffs brought claims under Minn. Stat. § 80A.23(1), which provides that, in an action for rescission and restitution based on the nonregistration of securities in Minnesota, "the purchaser shall be entitled to recover the consideration paid for the security * * * less the amount of any income received on the security." Because the Minnesota courts had not directly addressed the issue, we deferred to the district court's interpretation of "income received" as not including tax benefits. *Id.* at 440-41. We now overrule that decision.

limit damages to the "actual damages" sustained), but also to the common law fraud claim[7] and the claim un-

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We do not believe that Minnesota could have intended to treat fraudulent sellers more kindly than those who have simply neglected to register their securities. Although the phrase "actual damages" does not appear in subsection (1), the principle that a plaintiff should not be placed in a better position than he would have been in but for the fraud — the principle, in other words, that no recovery in excess of actual damages should be permitted — is plainly implicit in that provision. In actions for rescission based on sales of unregistered securities, the statute says, "the amount of any income received on the securities" is to be subtracted from "the consideration paid for the security together with interest" in computing damages.

Moreover, to allow greater recoveries under subsection (1) than under subsection (2) leads to results that are anomalous in the extreme. Subsection (1) governs not only simple actions for sale of unregistered securities (arising under Minn. Stat. §80A.08), but also actions for misrepresenting that registration of a security means that state officials are recommending that security (a practice made unlawful by Minn. Stat. §80A.18). Otherwise, a defendant who tells a buyer that the filing of a registration statement means that the Commissioner of Commerce is recommending purchase of the security registered would be liable for the full amount of consideration paid, and would receive no credit for tax benefits conferred on the buyer, however substantial. But a defendant who commits some other kind of fraud, however flagrant, would receive such credit, solely because the action against him arises under §80A.23(2) instead of §80A.23(1). The Minnesota Supreme Court, of course, can resolve this matter authoritatively and have the last word on the subject.

Our brother Heaney, *post* p. 26, takes the position that "it is bad policy" to reach the *Hayden* issue because it "was not presented to us by the parties" and "we need not decide" it. We would like to explain briefly why we disagree with this statement. The Court en banc was convened to decide whether we should adhere to the panel's decision in *Austin I*. Plaintiffs, seeking disapproval of *Austin I*, argued that it was inconsistent with *Hayden*. We agree. The logical implications of *Austin I*, which is now approved by the Court en banc, are completely inconsistent with *Hayden*, for reasons we have given. The Court en banc is convened infrequently, though perhaps not infrequently enough, and we believe it is good judicial policy to use those infrequent occasions to bring consistency to our case law. If we were to leave *Hayden* on the books, without indicating one way or the other whether it is still good law, we would almost guarantee that the Court en banc would have to meet again when the *Hayden* issue arose, unless, of course, the Supreme Court of Minnesota had, in the meantime, resolved the question, an event the likelihood of which we have no way of estimating. For these reasons, we believe it is a wise use of the Court's time and energy to say now that *Hayden* is inconsistent with the position we now take in *Austin II*, and, therefore, to state unequivocally that *Hayden* is abandoned.

[7] In *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980), the Court implied that tax benefits must be considered in determining damages under a Minnesota common law securities fraud

der section 12(2) of the 1934 Act. Although the 1934 Act does not explicitly limit rescissionary damages to "actual damages" sustained, we noted that:

> Under § 12(2), the defendant guilty of prospectus fraud shall be liable to plaintiff, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, *less the amount of any income received thereon,* upon the tender of such security, or for damages if he no longer owns the security.

Id. at 181 (emphasis in original).

Because we found that section 12(2) implicitly incorporates the "actual damages" principle and that the words "income received" should be construed as including the tax benefits bargained for and received in the special case of a tax shelter investment, we concluded that the plaintiffs' damages must be reduced by the tax benefits they received.

The plaintiffs now contend that we should reconsider both of the above findings of *Austin I*. First, they argue that the "actual damages" language in section 28(a) of the 1934 Act does not justify subtracting tax benefits from awards under section 12(2) of the 1933 Act because section 28 (a) applies only to the 1934 Act and the words "actual damages" do not appear anywhere within the 1933 Act. We reject this contention. Although the words "actual damages" do not appear in the 1933 Act,

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claim, at least where the case involves a limited partnership offering which includes the promise of artificial tax savings. 290 N.W.2d at 615-16. *See* note 4, *supra. See also Weise v. Red Owl Stores, Inc.*, 286 Minn. 199, 175 N.W.2d 184, 187 (1970) (the out-of-pocket rule also governs an award of damages for common law securities fraud).

the courts have nonetheless applied the actual damages principle of section 28(a) to bar punitive damages[5] under section 17(a) of the 1933 Act, *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1278, 1283-86 (2d Cir.), *cert. denied*, 397 U.S. 913 (1970), and have construed the rescission and restitution remedy provided by section 12 (2) as substantially equivalent to the damages permitted under section 28 (a). *Cf. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972). The goal of rescission under section 12 (2) is to return the parties to the status quo *ante*, "and hence a plaintiff can recover no more than his or her 'net economic loss,' " *i.e.*, "actual damages." *Salcer*, 744 F.2d at 940; *Austin I*, 675 F.2d at 181; *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 49 n.22 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

We also reject plaintiffs' contention that tax savings are neither "income" nor are they "received" within the meaning of section 12 (2). They cite *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) in support of their argument, but that case is inapposite. The plaintiffs in *United Housing* were tenants who were required to purchase refundable non-interest bearing shares in a non-profit housing cooperative in order to rent a low-cost apartment. After a rent increase was imposed to meet costs, plaintiffs brought fraud claims under the Securities Act of 1933 and the Securities Exchange Act of 1934, alleging that they were misled in the purchase of the shares by misrepresentation in the cooperative's information bulletin.

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[5]We reject the SEC's argument that the actual damages principle is only intended to prohibit awards of punitive damages or duplicate state and federal recoveries based on the same conduct. *See also Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63, 70 (8th Cir. 1980), *cert. denied*, 499 U.S. 1079 (1981).

The Court looked to "economic reality," 421 U.S. at 848, in determining that the shares were not securities. It noted that the plaintiffs' purchase of the shares was motivated by a desire to obtain housing, not to make a profit in the sense of a "return on investment." The Court was not persuaded that the plaintiffs expected a profit on their non-interest bearing refundable shares (which were akin to a "security deposit") simply because they were able to reduce their taxes by deducting that portion of their monthly rental charges which were applied to interest on the mortgage. 421 U.S. at 855. The Court noted that "[e]ven if the tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others." *Id.* 421 U.S. at 856 n.20.

United Housing is not only distinguishable on its facts; if anything, its analysis tends to support our position in *Austin I*. Like the *United Housing Court*, the *Austin I* Court looked to "economic reality" in considering the tax aspects of a tax shelter investment.[9] Additionally, unlike the marginal tax benefits referred to in *United Housing*, the tax benefits in the case at hand were a primary motivation behind the investment and resulted from Loftsgaarden's efforts in structuring and operating the partnership to take advantage of relatively complicated tax rules. *See Salcer*, 744 F.2d at 941 ("plaintiffs' argument

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[9] *See also Salcer*, 744 F.2d at 941 ("To ignore the state's tax benefits actually realized by the plaintiffs would be unrealistic."); *Bridgen v. Scott*, 456 F. Supp. 1048, 1061 (S.D. Tex 1978) ("Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and this Court to live in an artificial 'never-never' land. The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.").

that defendants are not entitled to 'credit' for the tax benefits because the latter were 'provided' by the government rather than by the defendants must be rejected * * * [T]hat the tax benefits were paid by the government rather than by the defendants does not lessen the defendants' role in securing them.").

In any event, *Austin I* did not hold that tax benefits received are a form of income in a strict accounting sense.[10] Rather, we held that section 12(2)'s requirement that "income received" be deducted in determining rescissionary damages simply reflected that all economic benefits bargained for and received must be deducted from plaintiffs' damages because "the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs." *Austin I*, 675 F.2d at 183.

The plaintiffs claim that their tax benefits have not been "received" must also be rejected because they have stipulated that they have received permanent tax benefits from their investments in Associates. Similarly, we reject the contention of the Tax Division and the SEC that plaintiffs' tax benefits "may" prove to be illusory because they "may" experience recapture upon sale or other disposition of the hotel. All of the plaintiffs in this case have already experienced all possible recapture when the hotel was foreclosed upon in 1978 We also reject, as without a factual basis, the Tax Division's claim that "it is far from clear that all the proper income recognition and recapture provisions were taken into account." Brief of

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[10]Loftsgaarden, in an apparent change in strategy, now contends that the tax benefits are not income received but are instead a return of consideration. We address this claim *infra*.

Tax Division at 11. All of the plaintiffs' tax returns from the relevant tax years have already been audited and are now closed.

We also find without merit the Tax Division's claim that, under the "tax benefit rule," the plaintiffs, upon receiving rescissionary damages, will have to amend their prior tax returns to eliminate all tax benefits previously received as a result of their investments in Associates. The "tax benefit rule" does not require elimination of tax benefits already received. *See Hayden v. McDonald,* 742 F.2d at 440. Rather, it provides that a taxpayer who claims a deduction resulting in a tax benefit one year and who later obtains a recovery or repayment in a later year must include the recovery or repayment as ordinary income in the year of recovery.[11] *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S. Ct. 1134, 75 L.Ed.2d 130, 142-44 (1983); *Salcer,* 744 F.2d at 943; 1 Mertens, *Law of Federal Income Taxation,* § 7.34 at 7-115, § 7.37 at 7-130. We need not address the contention of the Tax Division and the SEC that the tax consequences of the rescissionary award will "wash out" any prior tax savings, because we are not presented with such a situation in this case.

The plaintiffs next contend, with support from the SEC, that the collateral source rule requires that Section 12(2) awards not be reduced by tax benefits. This rule "prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insur-

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[11]We need not decide whether a different situation might exist in a case involving actual rescission. *See Salcer,* 744 F.2d at 943; *Burgess v. Premier Corp.,* 727 F.2d at 838.

ance policies negotiated independently." *Salcer*, 744 F.2d at 941. We agree with the *Salcer* Court that the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award." *Id.* at 941-42.

For similar reasons, we reject plaintiffs' claim that we should ignore their tax benefits because otherwise the defendants will unjustly "retain" the consideration previously paid by the plaintiffs. First of all, it does not appear that the defendant has "retained" any of plaintiffs' consideration; rather these monies were paid to the partnership and were invested in the project. Moreover, the purpose of the private civil remedies provided by the federal and relevant Minnesota securities laws is not to penalize defendants, but to compensate plaintiffs for any actual monetary loss. *See id.* at 941. This actual monetary loss cannot be determined without reference to tax benefits bargained for and received.

We also reject the similar argument of *amici* that deducting tax benefits from damages will deprive the government of just tax revenues. The government is entitled only to those revenues which are authorized under the tax laws. These laws create incentives for real estate projects to further public policy objectives, such as the creation of employment, enhancement of the real estate tax base and the local business climate. The Rochester Ramada project met all of the tax code criteria and thus generated the income tax benefits which the plaintiffs enjoyed. This case is therefore very similar to *Salcer*, where the Court stated:

> Nor can we agree with the notion that our ruling makes "the government the banker for fraudulent tax shelter activity," *Burgess v. Premier Corp., supra,* 727 F.2d at 838. As Judge Broderick noted, there was no such activity in this case; the fraud, if any, pertained only to the investment aspects of the Greenspoint Project. The government got the residential development that it hoped to encourage by offering the tax benefits taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

Id. at 941.

There is no legal justification for awarding a party damages to which he is not entitled merely to provide revenue for the government to tax.

Next, we reject plaintiffs' claim that the consideration of tax benefits in determining rescissionary damages in a tax shelter case creates unnecessary complexities. Our opinion in *Austin I,* 675 F.2d at 183, deals at length with this contention. We noted that "the complexity of evidence relating to plaintiffs' tax savings is not a viable reason for precluding such evidence in light of *Norfolk & Western R. Co. v. Liepelt,* 444 U.S. 490, 100 S. Ct. 755, 62 L.Ed 2d 689 (1980)." *Id.* We cannot agree that the retrial of the damages issue on remand reflects such complexity that *Austin I* must now be reversed.

Finally, plaintiffs and the SEC[12] contends that *Austin I's*

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[12]The SEC also argues that tax benefits should be considered in computing prejudgment interest, but not in computing damages. We agree with the *Salcer* Court, 744 F.2d at 942, that this argument "is so unrealistic and disproportionate as to border on the frivolous" and "must be rejected out of hand."

tax benefit offset rule discourages private enforcement of the antifraud provisions of the federal securities laws in an area in which the Commission itself is unable to devote substantial resources.[13] While it is unclear that this will be the result of the offset rule because most defrauded tax shelter investors will still be able to obtain at least some damages, we agree with the *Salcer* Court that it is for the legislature, not for the courts, to authorize the award of more than "actual damages" in order to encourage the filing of private damage actions. *Salcer*, at 941. *See also e.g., Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 420 (1975) (shifting of attorneys' fees by court to create incentives is impermissible).

In sum, we affirm the holding of *Austin I* "that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted." *Austin I*, 675 F.2d at 183-84.

II. *How should the plaintiffs' rescissory damages be computed?*

On remand, the district court first determined the amount of permanent tax benefits received by each of the plaintiffs as follows: Anderson, $29,615.00; Austin, $33,330.00; Neumann, $57,014.00; Randall, $36,404.00. The parties do not contest this finding; accordingly, we adopt these figures as the amount of tax benefits received by each plaintiff.

The court then determined that each plaintiff was en-

[13]Most tax shelter securities are sold in private offerings exempt from the registration requirements of the 1933 Act.

titled to prejudgment interest at the rate of eight percent simple interest[14] under section 12(2) of tht 1933 Act. The interest rate has been approved by the panel opinion announced today along with the *en banc* opinion.

The court then determined rescissory damages in accordance with the specific language of section 12 (2); cordance with the specific language of section 12(2); less the amount of any income received thereon." Under the district court's amended determination, this computation produced the following results:

Plaintiff Austin	
Consideration paid June 6, 1973:	$35,000
Simple interest at 8% to February 22, 1984:	$31,277
Subtotal	$64,610
Minus tax benefits:	— $33,333
Total damages:	$31,777
Plaintiff Neumann	
Consideration paid August 21, 1973:	$35,000
Plus consideration paid October 19, 1973:	$17.500
Simple interest at 8% to February 22, 1984:	$43,885
Subtotal	$96,385
Minus tax benefits:	— $57,014
Total damages:	$39,371

[14]The court originally ordered compound interest but amended its judgment by ordering simple interest.

Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000
Simple interest at 8% to February 22, 1984:	$28,770
Plus consideration paid 1975:	$2,512
Simple interest at 8% to February 22, 1984:	$1,691
Subtotal	$67,973
Minus tax benefits:	— $36,404
Total damages	$31,569
Plaintiff Anderson	
Consideration paid June 2, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$29,787
Subtotal	$64,787
Minus tax benefits:	— $29,615
Total damages:	$35,172

Although the parties and *amici* suggest several variations from this damage computation formula, we believe they raise only three serious contentions. First, defendant Loftsgaarden argues that, under the section 12(2) damage computation formula, tax benefits are a return of "consideration paid" and thus must be deducted from consideration paid before adding on interest. As the district court noted, this course would drastically reduce the awards to Anderson and Austin and eliminate the awards to Neumann and Randall. We agree with the district court that this approach must be rejected. As we noted

previously, *Austin I* did not indicate that tax benefits should be treated as a return of consideration. Instead, in holding that tax savings must be subtracted from damages we quoted section 12(2) and italicized the phrase, *"less the amount of any income received thereon." Austin I*, 675 F.2d at 181. Similarly, in *Hayden v. McDonald*, 742 F.2d at 441, we characterized *Austin I* as "implicitly construing the 'income' language in a federal securities statute to include tax considerations." At least one commentator has also characterized *Austin I* as "classifying tax benefits received by the plaintiff as 'income' within the meaning of section 12(2) of the 1933 Act." Note, *Austin v. Lotfsgaarden, etc.*, 16 Creighton L. Rev. 1140, 1151 (1983). *Cf.* S. Banoff, *"To What Extent Will Benefits From Tax Shelters Be Permitted to Offset Rescission Damages?,"* 57 J. Tax'n 154, 156 (1980).

Additionally, whether or not tax benefits may be considered "income" in a strict accounting sense, tax benefits are far more dissimilar to "consideration." Moreover, although we find that section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received, we do not agree that tax benefits can be considered a "return" of consideration.

Finally, treating tax benefits as consideration returned would, even under Loftsgaarden's calculations, mean that the plaintiffs would not be compensated for their actual damages. For example, using Loftsgaarden's calculations of plaintiff Neumann's net interest cost (as we explain further below), he would receive no damages even though

he suffered net economic loss of at least $992.[15] Loftsgaarden no doubt prefers the zero judgment figure to the $992 figure, in part because this would lend substantial support to his argument before the panel that Neumann is not entitled to the $29,000 in attorneys' fees granted by the district court. In short, we cannot agree that the district court erred in refusing to treat the tax benefits as a return of consideration for purposes of determining the order of computation under the formula set forth in section 12 (2).

Loftsgaarden next contends that the district court erred in awarding prejudgment interest on the total amount of consideration paid by each plaintiff from the date paid until February 22, 1984, rather than awarding interest only on the amount of money which each plaintiff was "out-of-pocket" during each year of the investment. We agree. The goal of prejudgment interest is to compensate plaintiffs for the loss of the use of their money. *See Cant v. A. C. Becker & Co.*, 384 F.Supp. 814 (N.D. Ill. 1974);

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[15]Loftsgaarden's calculations indicate that Neumann invested $52,500, lost $5,506 in opportunity cost on the use of his money at 8% simple interest and received $57,014 in tax benefits for a net economic loss of $992. By subtracting the $57,014 in tax savings from the $52,500 consideration paid, before considering Neumann's opportunity cost in that he did not receive the $57,014 back until several years after he invested the $52,500, Neumann receives zero in damages.

Loftsgaarden cites *Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1233 (D. Md. 1968), *aff'd in part and rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970) as support, but that case is inapposite. In that case, the court treated "repayment of *principal*" as a return of consideration. A repayment of principal bears no similarity to tax benefits received. However, even if we were to change *Austin I's* rationale and treat tax benefits as a return of consideration, plaintiffs at minimum would be entitled to their net opportunity cost in damages. This could be done by reducing the amount of the tax benefits received to present value at the time of the investment using, for purposes of this opinion, the 8% discount rate. We prefer, however, to affirm the district court's treatment of tax benefits as "income received."

Chris-Craft Industries, Inc. v. Piper Aircrafter Corp., 384 F.Supp. 507, 527 (S.D.N.Y. 1974), *modified*, 516 F.2d 172 (2d Cir. 1975), *rev'd on other grounds*, 430 U.S. 1 (1977). Because plaintiffs were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1307 (2d Cir. 1973) (prejudgment interest should be computed on the "net difference between value of assets given and value received"); *Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940) (reaching similar result by determining that plaintiff was entitled under section 12(2) "to recover the amount paid for [the security] with interest, less the amount received with interest").

Loftsgaarden has submitted what we find is a reasonably accurate determination of the net interest costs incurred by the plaintiffs taking into account the amount of money invested, and the tax benefits received by each plaintiff during each year of their investment in Associates. These calculations, prepared by John M. Carlson, Certified Public Accountant, are as follows:[10]

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[10]These calculations are based on the eight percent rate affirmed by the panel opinion attached at the end of this opinion. These calculations take into account recapture and also net out plaintiffs' interest costs by their interest gains on the amount of ordinary income above the amount of their investments retained in each year because of tax benefits conferred by their investments in Associates. These calculations also assume that each plaintiff did not receive the tax benefits until April 15 of each year, when their tax returns were due. Although this does not take into account the benefits of potential reduced payments of estimated tax, we find that the calculations present a reasonably accurate and straightforward method of determining net prejudgment interest costs.

RANDALL

	Invested	Net Reduction (increase in) Tax Liability Current	Carryback	Balance	Days	Interest Cost (earned) at 8% annum
11/13/73	35,000			35,000	153	1,174
4/15/74		4,499		30,501	365	2,440
4/15/75		21,268		9,233	365	739
4/15/76		10,481		(1,248)	365	(100)
4/15/77		10,272		(11,520)	365	(922)
4/15/78		7,297		(18,817)	365	(1,505)
4/15/79		(21,855)		3,038	365	243
4/14/80		4,442		(1,404)	1,339	(412)
12/15/83	35,000	36,404		(1,404)	3,682	1,657

ANDERSON

6/ 2/73	35,000			35,000	317	2,432
4/15/74		11,221		23,779	365	1,902
4/15/75		17,149		6,630	365	530
4/15/76		10,987		(4,357)	365	(349)
4/15/77		11,011		(15,368)	365	(1,229)
4/15/78		7,972		(25,340)	365	(1,867)
4/15/79		(35,974)		(12,634)	365	1,011
4/15/80		7,249		5,386	1,339	1,580
12/15/85	35,000	29,615		5,385	3,846	4,010

NEUMANN

8/21/73	35,000			35,000	58	445
10/19/73	17,500			52,000	178	2,048
4/15/74		19,560		32,940	365	2,635
4/15/75		9,858		23,092	365	1,847
7/15/75			3,677	19,415	91	387
4/15/76		14,431		4,984	274	299
4/15/77		4,888		96	365	8
7/15/77			77	19	91	
4/15/78		9,000		(8,981)	274	(539)
4/15/79		(5,236)		(3,745)	365	(299)
4/15/80		769		(4,514)	1,339	(1,325)
12/15/83	52,500	53,260	3,754	(4,514)	3,765	5,506

AUSTIN

6/26/73	35,000			35,000	293	2,248
4/15/74		13,066		21,934	365	1,755
4/15/75		19,259		2,675	365	214
4/15/76		10,863		(8,188)	365	(655)
4/15/77		3,324		(11,512)	365	(921)
4/15/78		7,646		(19,158)	365	(1,533)
4/15/79		(26,274)		7,116	365	569
4/15/80		5,449		1,667	1,339	489
12/15/83	35,000	33,333		1,667	3,822	2,166

SUMMARY

	Invested	+	Interest Cost	−	Tax Benefit	=	Damages and Interest
Randall	35,000		1,657		36,404		253
Anderson	35,000		4,010		29,657		9,395
Neumann	52,500		5,506		57,014		992
Austin	35,000		2,166		33,333		3,833

Next, both plaintiffs and defendants contend that in order for the plaintiffs to be truly made whole, and to be returned to the status quo ante, both the tax benefits received *and* the tax consequences of their recovery must be taken into account. *Dicta* in *Hayden v. McDonald*, 742 F.2d 423, 440 (8th Cir. 1984) supports this contention, and, as the parties are in agreement, we agree that the tax consequences of plaintiffs' recovery must be considered. The parties disagree on how these tax consequences should be determined. We find Loftsgaarden's method to be reasonably accurate and much simpler than plaintiffs' formula and thus adopt Loftsgaarden's method. This method, which was also used in the "Reardon Report," which was cited in *Hayden*, takes into account the fact that, because each plaintiff will have to pay taxes on his award, the award must be calculated in an amount which each plaintiff would have to recover in order to "net out" their actual damage figure. We assume that each plaintiff is still in the fifty percent tax bracket and thus must receive twice the above amount of damages and net interest cost. Thus, in accordance with the panel's affirmance of the eight percent simple interest rate, each plaintiff is entitled to a damage award as follows: Anderson ($9,395 x 2 = $18,790); Austin ($3,833 x 2 = $7,666); Neumann ($992 x 2 = $1,984); Randall ($253 x 2 = $506).

In conclusion, the Court *en banc* affirms *Austin I* but

vacates and modifies the district court's award of damages as set forth above.

There are three remaining issues which were initially heard by a panel of this Court. These issues are: (1) Whether the district court, on remand, erred in its interpretation of *Austin I;* (2) whether attorney fees should have been awarded; and (3) whether prejudgment interest was properly calculated. For convenience, the panel's opinion is incorporated herein:

Before LAW, Chief Judge, and ROSS and McMILLIAN, Circuit Judges.

Plaintiffs urge, on cross-appeal, that the district court should have allowed them to retry their case on the "out of pocket" damages theory. At the original trial the district court noted that "out of pocket" and rescissionary damages are essentially the same. However, plaintiffs hoped to avoid the *Austin I* mandate to consider tax benefits by changing to the "out of pocket" approach. On remand, the district court refused to allow the change in theories. We find no error. The plaintiffs tendered their shares to defendants shortly before the original trial and effectively elected the remedy of rescission. More importantly, plaintiffs should not be allowed to introduce a new theory some eight years later. The case is now in its second appeal, after two trials, both of which focused on rescissionary damages. We think it too late to change theories and find no abuse of discretion by either trial judge.

Plaintiffs also argue that *Austin I* applies only to investments "expressly structured and marketed as a tax shelter." *Austin I*, 675 F.2d at 183. According to plaintiffs no factual finding has ever been made that this particular invest-

ment was expressly structured and marketed as a tax shelter. The *Austin I* court defined a tax shelter as any investment which creates tax deductions through "artificial losses." *Id.* The court en banc has endorsed that definition. *Austin II*, slip op. at 3. The evidence shows plaintiffs were able to reduce their tax liability significantly in the first few years of the investment through accelerated depreciation and other deductions.

There are several contentions relating to attorney fees. Defendants contend Neumann and Randall failed to prove a cause of action which would support any award of fees and, even if they did, the amount awarded was excessive. Plaintiffs argue that the fees awarded were insufficient and, furthermore, that fees should have been awarded to Austin and Anderson.

First, the method of damage calculation determined by the court en banc makes it clear Neumann and Randall were damaged and proved a claim for relief. We find the award of fees to Neumann and Randall falls within the range of discretion of the district court. In weighing the arguments we find no abuse of discretion.

Second, plaintiffs cannot recover fees under federal securities statute. The award to Neumann and Randall was based on Minn. Stat. § 80A.23 (2) (1984). This statute was not in effect before August 1, 1973. It is clear from the record that Anderson and Austin purchased their securities prior to that date. Under these circumstances the district court was correct in holding that Anderson and Austin were barred from recovery of attorney fees.

The issue of the method of calculating interest has been resolved by the court en banc. Plaintiffs have argued that the rate, eight percent, was too law. Defendants, on the

other hand, argue no interest can be awarded to Neumann and Randall because they suffered no actual damage and thus failed to prove a cause of action. As noted previously, the court en banc's method of damage calculation shows Neumann and Randall did suffer damage and proved a cause of action. While the district court, on remand, was not bound by the original trial judge's use of eight percent as the rate of interest, plaintiffs point to no evidence in the record which would suggest a higher rate. Although we believe the rate of interest should be based on a finding of fact from evidentiary proof, in the absence of such proof we feel the district court did not err in applying an eight percent rate as a traditional and fair rate of interest.

The panel holds that the district court, on remand, correctly interpreted *Austin I* and did not err or abuse its discretion in the award of attorney fees and pre-judgment interest. In conclusion, we remand to the district court for entry of judgment as set forth in this opinion.

HEANEY, Circuit Judge, concurring and dissenting.

I concur in the majority"s opinion except insofar as it overrules *Hayden v. McDonald*, 742 F.2d 423 (8th Cir. 1984). I continue to believe that the issue is a doubtful one and that in cases of doubt we should give great weight to a decision of a United States District Court interpreting a statute of the state in which it sits. Moreover, I think it is bad policy to reach an issue that was not presented to us by the parties and which we need not decide.

LAY, Chief Judge, dissenting, joined by BRIGHT, Circuit Judge.

I incorporate my concurrence in *Hayden v. McDonald*, 742 F.2d 423, 441-42 (8th Cir. 1984), and the reasoning set forth therein for urging that tax benefits of plaintiffs in a rescissionary damage action have no relationship to their present claim. The Department of Justice and the Securities and Exchange Commission have presented strong arguments against appellants' theory in amicae briefs.

The majority invokes the doctrine of law of the case. As Judge Learned Hand observed many years ago: "[I]it is now well settled that the 'law of the case' does not rigidly bind a court to its former decisions, but is only addressed to its good sense." *Higgins v. California Prune & Apricot* Grower, Inc., 3 F.2d 896, 898 (2d Cir. 1924). A court should never be constrained by the weight of a prior erroneous decision. The purpose of an en banc hearing is to draw on the wisdom of the full court and rectify earlier errors. Reliance on precedent is a poor substitute for analysis.

The damages provisions of the federal statute, section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2), and the Minnesota Statute, Minn. Stat. § 80A.23 (1), are quite similar:

> § 12(2): * * * recover the consideration paid for such security with interest thereon, less the amount of any income received thereon * * *.
>
> § 80A.23(1): * * * recover the consideration paid for the security together with interest at the legal rate, costs, and reasonable attorney's fees, less the amount of any income received on the securities.

The key words are "less the amount of any income received * * *." The majority concedes that the tax benefits

received by plaintiffs are not really "income." Nonetheless, the court holds the benefits must be subtracted—notwithstanding the clear language of the statute—in order to give meaning to "actual income." As Judge Arnold notes in his concurrence, the present holding as to Minnesota law cannot be rationally squared with *Hayden*.

Loftsgaarden relies heavily on *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), *cert. pending*. The Salcer court was concerned the plaintiff might receive a windfall and, like the majority today, applied the tax benefits in favor of the defendant, transferring any possible windfall to the wrongdoer. The Ninth Circuit has held to the contrary, using the same reasoning I urge this court to adopt. *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir. 1984). The *Burgess* court found that "to simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally. * * * Such a result leaves the government bearing the cost of defendants' fraud." *Id.* at 838. *See also Western Federal Corp. v. Erickson*, 739 F.2d 1439, 1444 (9th Cir. 1984).

Application of tax benefits to lessen damages in a rescissionary suit actually fails to comprehend the principle behind a "tax shelter." The investor receives no money from the tax benefit; the investor simply is allowed to deduct a certain amount from his ordinary income or apply a credit toward tax owed for the particular tax year. The actual value of the benefit depends on the income bracket the investor is in, which in turn depends on other deductions that may be available to the taxpayer that year. This fact alone demonstrates how speculative any benefit in tax savings may be. More significantly, the tax benefit is not a real or actual savings—it is usually only a deferral of

tax. Ultimately, in a time of recapture when the investment is sold or otherwise disposed of, the taxpayer must return to the government tax benefits gained unless the investor suffers an actual loss. The court's conversion of the tax deferral to realized income by subtracting it from a plaintiff's damages provides a windfall to the defendant—the fraudulent party. The holding in this case violates the old principle that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965), *quoted in Myzel v. Fields*, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

In mitigation, the majority believes Loftsgaarden did not benefit from any of the consideration paid by plaintiffs. This is patently wrong. There was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme. Under the majority"s approach, Loftsgaarden gains both his own profit from the scheme and the advantage of plaintiffs' speculative tax benefits. Such a result seriously undercuts the broad protective purpose of the Securities Act of 1933. *See United States v. Naftalin*, 441 U.S. 768, 774-777 (1979).

The majority adopts the magnanimous suggestion in Loftsgaarden's brief that, in all fairness, plaintiffs' ultimate damages should be doubled in order to offset the tax consequences of recovery—assuming plaintiffs are in the fifty percent bracket. This serves to demonstrate how speculative and inaccurate the consideration of tax consequences can be in a suit involving rescissionary damages. A defendant should not have to pay damages based on the plaintiff's tax bracket in a given year. This is not a dam-

age caused by the defendant. Their theory is that to make plaintiffs whole and restore the status quo ante we must account for the tax treatment of plaintiffs' recovery. However, the relevant statutes clearly require the court to restore the consideration paid to the defrauding party, with interest, less any income actually received from the investment. And tax benefits concededly are not income received from the investment.[1] Consideration of tax benefits involves the court in the problems of recapture and net gains or losses. In turn, the court finds it must consider each plaintiff's income and deductions in the year of recovery to net out "actual damages" based on applicable tax rates. Rather than making up an artificial theory of damage by doubling the net gain, it is much simpler and more accurate to provide the plaintiff with restitution of his investment. The statutes provide a clear and simple formula. For example, Anderson invested $35,000 for a period of seven years. Loftsgaarden paid Anderson no interest or dividends and returned no principal. Anderson should recover $35,000 with interest for those seven years. Anderson will have to pay tax on the interest at ordinary income rates. In addition, he may be required to recapture past benefits. The tax transaction is between Anderson and the government and should not affect Loftsgaarden's liability. By this method a plaintiff recovers exactly what he lost: the principal, and interest he would have earned had that principal been invested in a legitimate security.[2]

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[1]If depreciation deductions were actually "income," then every taxpayer who takes such a deduction would have to include it as gross income on the next year's tax return, rather than applying it to the property's basis.

[2]It is reasonable to assume that if plaintiffs had not invested in Loftsgaarden's fraudulent scheme, they would have invested in another legitimate project which would have returned similar tax benefits as well as principal and interest over the life of the investment. The majority's approach will not make plaintiffs truely whole because the tax benefits are subtracted from the return of principal and interest.

This procedure is far more simple than requiring trial courts to undertake complicated and speculative evidentiary hearings on the mechanics of tax deferral plans and plaintiffs' tax status in given years of investment.

Today's holding provides the wrongdoer a surety by which to avoid liability, allowing the fraudulent party to use the United States Treasury for security in any fraudulent transaction. To the extent a defendant can, by his wrongful act, create a tax loss for the innocent victim, the defendant will be allowed to escape liability, shifting the burden of the loss onto the government. I do not believe section 12(2) or section 80A.23 (1) was designed to accomplish this result. Accordingly, I dissent.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Dr. Roger E. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,

Plaintiffs,

vs.

B. J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation; M.S. Noah; John W. Burg; Lyman H. Coult; Robert R. Dunlap; and Property Development & Research Company, a Minnesota corporation,

Defendants.

Civil 4-76-82

AMENDED JUDGMENT

Upon defendants' motion for amended findings of fact and an amended judgment, and pursuant to Fed. R. Civ.P. 52 and 59, this court finds that the amount of prejudgment interest awarded to plaintiffs in its order of February 22, 1984 be amended as follows to reflect simple interest at 8 per cent:

Plaintiff Anderson	
Consideration paid June 2, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$64,787
Minus tax benefits:	$29,615
Total damages:	$35,172

Plaintiff Austin	
Consideration paid June 6, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$64,610
Minus tax benefits:	$33,333
Total damages:	$31,277
Plaintiff Neumann	
Consideration paid August 21, 1973:	$35,000
Plus consideration paid October 19, 1973:	$17,500
Plus interest at 8% to February 22, 1984.	$96,385
Minus tax benefits:	$57,014
Total damages:	$39,371
Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$63,770
Plus consideration paid 1975:	$2,512
Plus interest at 8% to February 22, 1984:	$4,203
Sub total:	$67,973
Minus tax benefits:	$36,404
Total damages:	$31,569

This order amends only the interest calculations of the February 22 order, and the rest of that order—including awards of attorneys' fees and costs—stands intact.

IT IS SO ORDERED.

Dated: March 26, 1984.

/s/ Miles W. Lord
Chief Judge

APPENDIX C

(Title of Cause.)

Civil 4-76-82

ORDER

The plaintiffs in this case are four investors in a limited partnership who claim they were defrauded by defendants because of misrepresentations, half-truths and omissions in the Offering Memorandum used to attract them to a project to build and operate a Ramada Inn in Rochester, Minnesota. In a 1980 trial before Judge Larson of this court, plaintiffs prevailed on various claims against defendant B. J. Loftsgaarden and three of his closely-held corporations (hereinafter Loftsgaarden).[1] A jury found Loftsgaarden liable on claims under §10b(5) of the Securities Exchange Act of 1934, Rule 10b-5, Minn. Stat. §80A.01 *et seq.*, 80A.123, and common law fraud. The jury also found, in an advisory opinion adopted by Judge Larson, that Loftsgaarden had violated § 12(2) of the Securities Act of 1933.

Loftsgaarden appealed. The Eighth Circuit Court of Appeals affirmed on the issue of liability, but remanded on the issue of damages. *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982). Specifically, the appeals court held that the amount of tax benefits received by plaintiffs as a result of this investment must be deducted from the damages assessed against Loftsgaarden. *Id.* at 183-84.

This court held a bench trial on the tax benefits question on December 2, 1983, after which time the parties submitted additional briefs and affidavits. In addition to tax

[1]Defendants Noah and Coult were found not liable.

benefits, two other issues are now before this court: whether plaintiffs are entitled to prejudgment interest and whether plaintiffs are eligible for an award of attorneys' fees against Loftsgaarden.

AMOUNT OF TAX BENEFITS RECEIVED BY PLAINTIFFS.

At the 1980 trial, Judge Larson refused to admit Loftsgaarden's evidence on the amount of tax write-offs these high-income plaintiffs enjoyed as a result of their Ramada investment losses, stating that the court was "not going to get into a lot of complicated tax testimony." (T. 23) Judge Larson later characterized Loftsgaarden's tax benefit argument as "sophistic malarky." Memorandum Order No. 4-76-82 (D. Minn. Aug. 15, 1980).

The appeals court saw otherwise:

> [W]e hold that the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs.
>
> ***
>
> In conclusion, we hold that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor must be permitted.

Austin, 675 F.2d at 181 and 183-84.

At the December hearing before this court, three of the four plaintiffs accepted Loftsgaarden's calculations on the

amount of tax benefits they had received. Therefore, this court also adopts Loftsgaarden's accounting on these three plaintiffs as follows:

Anderson tax benefits:	$29,615.00
Austin tax benefits:	$33,333.00
Neumann tax benefit:	$57,014.00

The fourth plaintiff, Randall, refused to concur with the computations of Loftsgaarden's accountant. Indeed, plaintiff Randall continued to steadfastly maintain that he received no tax benefits at all in an argument that appears to be an attempt to reopen the issue conclusively decided by the Eighth Circuit. *See* Plaintiff Randall's Trial Brief at 5-6. This court refuses to entertain such an argument at this juncture in the proceedings.

Plaintiff Randall also asserted that he is entitled to rescind his entire investment, thereby recovering his money and amending his IRS returns to disgorge any tax benefits. Under this approach, plaintiff Randall again declares that there are no tax benefits to charge against his damage award. However, this court finds Randall's argument to be an untimely attempt to change the damage theory in this case. Both Judge Larson and the Eighth Circuit held that plaintiffs were entitled to a rescissory measure of damages, not rescission itself. By attempting to change the theory of damages at this late date, plaintiff Randall is struggling to further protract and complicate a proceedings that has already dragged on far too long. That will not be tolerated by this court.

Finally, plaintiff Randall submitted an accountant's calculations under this court's and the Eighth Circuit's theory of damages that is at odds with that of Loftsgaarden's ac-

countant. Randall claims his tax benefits totaled $26,-085.59; Loftsgaarden claims the figure is $36,404. At the December trial, it was established by the testimony of the accountants that the major factor producing different numbers was that Randall's accountant used an estimated tax rate of 54 percent, while Loftsgaarden's used the actual rates reflected in the returns. Obviously, this court finds that it is more appropriate to employ actual rates and therefore accepts Loftsgaarden's accounting. Thus, it is the finding of this court that plaintiff Randall's tax benefits from this investment amounted to $36,404.

PREJUDGMENT INTEREST

All plaintiffs assert that they are entitled to prejudgment interest on their damages awards under both § 12(2) of the Securities Act of 1933, 15 U.S.C. 1(2), and Minn. Stat. §80A.23, subd. 2. These statutes read as follows:

> Any person who ... offers or sells a security ... [in violation of this paragraph] ... shall be liable to the person purchasing such security from him, who may sue ... in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security ...

15 U.S.C. § 77*l*(2).

> Any ptrson who violates Section 80A.01 ... shall be liable to any person damaged thereby ... to whom he sold such security .... Damages in an action pursuant to this subdivision shall include the actual damages sustained plus interest from the date of payment ..., costs and reasonable attorneys' fees.

Minn. Stat. 80A.23, subd. 2.

In his post-trial memorandum, Judge Larson awarded prejudgment interest at the traditional rate of 8 percent to all plaintiffs under the federal statute cited above. Judge Larson found that plaintiffs Randall and Neumann also would be entitled to interest under the Minnesota Statute, but that plaintiffs Austin and Anderson were not covered by the state law because they invested prior to the act's implementation date. Since the Eighth Circuit did not disturb Judge Larson's ruling that Loftsgaarden was liable to all plaintiffs under the federal statute, this court reiterates his order that all plaintiffs be awarded prejudgment interest at 8 percent under §12(2) of the Securities Act.

CALCULATION OF DAMAGES

Based on the foregoing discussion, the starting point for assessing damages will be the amount each plaintiff paid Loftsgaarden for his investment (in other words, the plaintiff's consideration). To this, the court will add 8 percent interest from the date the consideration was paid to the date of this order. Finally, the amount of each plaintiff's tax benefits will be subtracted from the sum of his consideration and interest. This computation produces the following results:

Anderson	
Consideration paid June 2, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$79,905.00
Minus tax benefits:	$29,615.00
Total Damages:	$50,290.00

Austin	
Consideration paid June 26, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$79.501.00
Minus tax benefits:	$33,333.00
Total Damages:	$46,168.00
Neumann	
Consideration paid August 21, 1973:	$35,000.00
Plus consideration paid October 19, 1973:	$17,500.00
Plus interest at 8% to February 22, 1984.	$117,532.00
Minus tax benefits:	$57,014.00
Total Damages:	$60,518.00
Randall	
Consideration paid November 13, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$77,189.00
Plus consideration paid 1975:	$2,512.00[2]

[2]This additional item of consideration stems from $7,500 in loans from Randall to Loftsgaarden. The full amount of these loans cannot be included in Randall's consideration since the jury found, and Judge Larson and the Eighth Circuit concurred, that there was no liability for the loans because there was no reliance on misrepresentation at the time the loans were made. However, since Loftsgaarden included the $7,500 in Randall's basis for his calculation of tax benefits (which inures to Loftsgaarden's benefit), Randall should be able to claim that amount as income invested. According to Loftsgaarden's accountant, inclusion of the $7,500 in Randall's basis generated tax benefits of $2,512. (Randall's accountant states that inclusion of the loans resulted in tax benefits of $2,025. Since no clear indication is given as to how this figure was arrived at, the court accepts the calculations of Loftsgaarden's accountant. Surprisingly, Randall's calculations is more favorable to the defendant than the defendant's own figure.)

Plus interest at 8% to February 22, 1984:	$4,650.00
Subtotal:	$81,839.00
Minus tax benefits:	$36,404.00
Total Damages:	$45,435.00

Defendant Loftsgaarden disputes this straightforward method of computation. His approach would be to subtract the tax benefits from consideration paid before adding on interest, a course that drastically reduces or completely obliterates each plaintiffs award. However, the clear language of § 12(2) presents the order in which to consider these items. "consideration paid ... with interest thereon, less the amount of any income received ...." These words present an express directive to this court, and defendant cites no cases directly on point which hold to the contrary.

ATTORNEYS' FEES

All plaintiffs have petitioned this court for attorneys' fees under Minn. Stat. §80A.23, subd. 2, which specifically provides for such an award. (None of the federal statutes involved in this case authorizes attorneys' fees.)

As noted above, however, §80A.23 does not apply to all plaintiffs. Austin and Anderson purchased their interests in the limited partnership before August 1, 1973, the statute's effective date. Judge Larson found that these dates of sale were the crucial determinants in deciding whether these two plaintiffs were covered by the new statute, since the facts which formed the basis of their claims was the fraud which took place when they purchased their interests. Austin and Anderson point to some broad language in the Eighth Circuit opinion to support their contention that the new statute embraces their claims.

However, there is no indication anywhere in the opinion that the Eighth Circuit was doing anything more than affirming Judge Larson's findings on liability. Therefore, in accordance with Judge Larson's opinion, this court finds that only plaintiffs Randall and Neumann can recover their attorneys' fees.

This ruling is somewhat mitigated by the fact that Austin and Anderson shared attorneys with Neumann. As Judge Larson found, most of the work performed by these plaintiffs' attorneys would have been done even if Neumann had been the only client.

Judge Larson granted attorneys' fees of $10,000 to Randall and $15,000 to Neumann. In addition, Judge Larson awarded costs of $1,308.62 to Randall and $2,-210.53 to Neumann, Austin and Anderson. These amounts have never been paid. This court now orders that they be paid pursuant to this memorandum.

The fees considered by Judge Larson were those incurred through the trial of this action. Attorneys' fees covering the appellate proceedings have already been paid. Remaining for consideration, then, is the post-appellate phase of this suit, that is, time spent on the issues of damages and prejudgment interest.

For this segment, plaintiffs Neumann, Austin and Anderson request attorneys' fees of $16,174.17 based upon hourly rates of $60 to $135. Plaintiffs' attorneys faced a complex case and a zealous defense. As already noted, although only Neumann is entitled to fees, much of the work was done for these three plaintiffs as a group by their common attorneys. This court finds that a reasonable fee for Neumann would be $14,000 and also awards these three plaintiffs costs of $3,111.30. *See Zoll v. Eastern*

Allamakee Community School District, 588 F.2d 246 (8th Cir. 1978); *State v. Paulson,* 188 N.W.2d 424 (Minn. 1971).

Plaintiff Randall requests attorneys' fees of $14,825 based upon rates of $50 to $100. However, this request is based on a recalculation by Randall's attorney who went back through his time records to update his hourly fee to the rate he currently charges, not the rate he charged at the time the work was performed. This court finds that a reasonable fee would be $10,000 plus costs of $1,647.87.

SUMMARY

Based upon the foregoing discussion, IT IS HEREBY ORDERED THAT:

1. Damages awards be granted in the following amounts:

Anderson:	**$50,290.00**
Austin:	$46,168.00
Neumann:	$60,518.00
Randall.	$45,435.00

2. Attorneys' fees be granted as follows;

Neumann:	$29,000.00
Randall:	$20,000.00

3. Costs be granted as follows:

Anderson, Austin and Neumann:	$5,321.83
Randall:	$2,955.49

IT IS SO ORDERED.

Dated: February 22, 1984.

/s/ Miles W. Lord
Chief Judge

APPENDIX D

No. 80-1771
No. 80-1874

Dr. Roger E. Austin, Dr. Thomas W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,
Plaintiffs, Appellees and Cross Appellants,

v.

B. J. Loftsgaarden; Alotel Incorporated, a Minnesota Corporation; M. S. Noah; Lyman H. Coult; Property Development & Research Company, a Minnesota Corporation; and 2361 Building Corporation, a Minnesota Corporation,
Defendants, Appellants and Cross Appellees.

Appeal from the United States District Court for the District of Minnesota

Submitted: June 17, 1981
Filed: April 7, 1982

Before McMILLIAN and ARNOLD, Circuit Judges, and HANSON, Senior District Judge

HANSON, Senior District Judge.

Plaintiffs-appellees are four of twenty-two limited partners who invested in a development to build and operate a Ramada Inn Motel in Rochester, Minnesota. In the district court they prevailed on various claims that they were defrauded by defendants-appellants B. J. Loftsgaarden and

three of his closely-held corporations because of misrepresentations, half-truths, and omissions that were found to exist in the Offering Memorandum used to attract plaintiffs to the project.[1] A jury found Loftsgaarden and the corporate defendants (hereinafter Loftsgaarden) liable upon claims under § 10 (b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j (b); Rule 10b-5, 17 C.F.R. § 240.10b-5; the antifraud provisions of the Minnesota Securities Act, Minn. Stat. §§ 80A.01, 80A.23; and common law fraud.[2] The jury also rendered an advisory ver-

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[1]Defendants Noah and Coult, officers and directors of the corporate general partner, Alotel, Inc., were found not liable.

[2]§10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any national securities exchange—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 implementing §10(b), 17 C.F.R. §240.10b-5, provides:

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Minn. Stat. §80A.01 provides:

> It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (a) to employ any device, scheme or artifice to defraud;
>
> (b) to make any untrue statement of a material fact or to omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

dict—in which the district court concurred—that defendoants were liable for violating § 12(2) of the Securities Act oof 1933. 15 U.S.C. § 77*l*(2).[2] The district court applied a rescissory remedy, which resulted in an award to plaintiffs in the amount of the consideration that each had paid for his limited partnership unit or units, prejudgment interest from the date of purchase, and attorneys' fees for plaintiffs Randall and Neumann for a total judgment of $273,720. Defendants raise a number of issues on appeal mainly relating to the sufficiency of evidence on the essential elements of these claims and the measure of damages. Plaintiffs cross-appeal from the district court's denial of certain portions of their requested attorneys' fees. We affirm as to the finding of liability, but remand for further consideration on the issue of damages.

I.

B. J .Loftsgaarden is an attorney and the president and sole shareholder of corporate defendants Alotel, Inc., Property Development and Research Company (PDRC),

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[2] § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2) provides in pertinent part:

> Any person who —
>
> (2) offers or sells a security . . ., by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

and 2361 Building Corporation. Through these corporations, Loftsgaarden intended to build and operate a Ramada Inn in Rochester, Minnesota.[4] To help finance the $3.5 million project, he organized a limited partnership, Alotel Associates, through which he expected to raise $1 million by selling 40 limited partnership units to not more than 20 investors for $25,000 per unit. The remainder of the money was to be obtained through a $2.31 million mortgage loan from Larwin Realty and Mortgage Trust[5] and a $240,000 furniture and fixtures loan from the First National Bank of Rochester. Loftsgaarden and Alotel, Inc., were to serve as the project's general partners.

In December 1971, Loftsgaarden prepared an offering memorandum through which he hoped to interest investors in the limited partnership units. The memorandum indicated that the partnership would "operate as a 'tax shelter' ", leading to "significantly greater returns for persons in relatively high income tax brackets." Accordingly, the memorandum outlined "Investor Suitability Standards" requiring that each investor have a net worth in excess of $200,000 excluding home and automobiles or that some portion of the investor's income was subject to federal and state income taxes at a rate of fifty percent or more. Paul Crawford, an investment advisor whom Loftsgaarden knew was not licensed to act as such, agreed to help Loftsgaarden find suitable high income investors.

The attraction of such an investment to high tax bracket

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[4]PDRC was the entity through which the real estate would be obtained and 2361 was to serve as the project's general contractor.

[5]The $2.31 million loan would initially be made by First National Bank of St. Paul, which would supply interim construction financing to the partnership. Once motel construction was completed, Larwin would buy the loan from the St. Paul bank pursuant to a "take-out" commitment and put in its place a first mortgage.

individuals lies in the tax treatment of the partnership's income and losses. Because the partnership is not taxed as an entity, it serves as a conduit to the partners for all its taxable income and losses. I.R.C. §§ 701, 702. Each partner is permitted to take his or her share of the partnership's deductible losses "to the extent of the adjusted basis of such partner's interest in the partnership...." I.R.C. § 704 (d). But in a real estate investment such as the one contemplated by Loftsgaarden, the limited partner's basis is not restricted to the amount of his actual investment (the amount "at risk"); rather, it may be increased by the partner's proportional share of any nonrecourse loans made by the partnership. *See* I.R.C. § 465 (c) (3) (D). Against such an increased basis, a limited partner is able to receive from the partnership deductible losses far in excess of the amount he or she has at risk in the investment. By using accelerated methods of depreciation, prepaying interest on loans, renting instead of purchasing land, and other methods, the partnership is able artificially to generate large amounts of deductible losses and expenses in the early years of the venture which are passed on to the partners to use in offsetting other income on their individual tax returns.[6] The result is that a

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[6]One commentator offers the following example:

> A hypothetical real estate partnership might show a $50,000 loss in one year. Assume that this loss was obtained by taking the difference between $60,000 of deductible depreciation and $10,000 of gross rents in excess of operating expenses and interest. If mortgage amortization, a nondeductible expense, were $2,000, then the partnership would have a positive cash flow of $8,000. If under the partnership agreement, one limited partner were entitled to 50% of the partnership losses and 37.5% of the cash flow, that partner would receive $3,000 in cash, but his tax return would reflect only his share of the partnership's net loss, or $25,000.

Note, *Real Eestate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 Va.L.Rev. 669, 673 n.22 (1977). *See also* T. Dahlk, *Real Estate Partnerships and the Securities Laws: A Primer*, 12 Creighton L.Rev. 781, 783 (1979); R. Hrusoff, *Securities Aspects of Real Estate Partnerships*, 11 Ca.W.L.Rev. 425, 458 (1975).

limited partner can often recoup his money in the year of his investment through tax savings. Generally the tax shelter serves only to defer taxation until the investment is liquidated and each partner receives his or her proportional share of the proceeds of the sale. Any gain realized will be taxed partly at capital gains rates (assuming the greater than one year holding period has been satisfied) and partly at ordinary income rates (to the extent that the accelerated depreciation taken exceeds the amount that would have been taken if a straight-line method were used). I.R.C. §§ 1231, 1250.

Under the terms of Loftsgaarden's offering memorandum, Alotel Associates planned to employ some of the above-described methods to provide immediate tax savings to the limited partners. The $2.31 million loan from Larwin would be a nonrecourse loan, thus serving to increase each limited partner's investment basis. In addition, rapid depreciation methods would be used to generate large deductible losses in the early years of the investment. Despite these features, only one person was willing to make the $50,000 minimum investment. This forced Loftsgaarden to terminate the offering and revise the project to further enhance the tax benefits and reduce the minimum price per investor. Instead of purchasing land as originally contemplated, the partnership would rent land thereby incurring another tax deductible expense.[7] Since capital

[7]The land rental would be effected through a sale-leaseback arrangement whereby the partnership would acquire the land, sell it to a third party, and then lease it back from the third party purchaser. In reality, the transaction worked as follows: Part of the land was purchased by the partnership and then sold to Loftsgaarden's corporation, PDRC. In turn PDRC purchased the remainder of the land outright, then sold the entire parcel to a third party, which leased the land back to PDRC. Then PDRC subleased the land back to the partnership.

was no longer required to purchase land, the amount of money Loftsgaarden needed to raise through the sale of limited partnership units was reduced from $1 million to $700,000. This also reduced the minimum investment per limited partner from $50,000 to $35,000 and the total number of units from 40 to 20.

In May 1973, Loftsgaarden revised the offering memorandum to reflect these changes. An accounting forecast included in the memorandum stated that the partnership would suffer losses resulting in income tax savings during its first three years; thereafter the business would begin to show a profit. Again Crawford aided Loftsgaarden in finding suitable high income investors. This time the offering proved successful. In the summer and fall of 1973, plaintiffs—Drs. Roger Austin, Thomas Anderson, Myrel Neumann, and William Randall—were among those who purchased units.[8] The jury found that plaintiffs bought their units in reliance on the representations made in Loftsgaarden's offering memorandum and upon the advice of either Crawford[9] or their own financial advisors who in turn relied on the memorandum.

Among other matters, the offering memorandum represented that Loftsgaarden could obtain interim construction financing for the motel at an interest rate of nine and one-half percent; that the construction loan interest would amount to $130,000; that the land lease would run for forty years with renewal and purchase options; that construction of the motel would begin in May 1973 and be completed seven months later in December 1973; that the

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[8]Plaintiffs each purchased one $35,000 unit except for Dr. Neumann who bought one and a half units for a total investment of $52,000.

[9]Loftsgaarden admits that Crawford made no representations "other than those in the Offering Memorandum." **Brief for appellants at 16.**

developer and the construction company (i.e., Loftsgaarden and 2361) would receive $103,000 for "overhead and profit"; that the $240,000 furniture and fixtures loan from the Rochester bank would be at an interest rate of eight percent; and that Alotel Associates had procured a firm commitment for long term financing[10] from Larwin. Findings of Fact, Conclusions of Law, and Order for Judgment, Designated Record (D.R.) 445-59.[11]

These representations were found to be false. In fact, Loftsgaarden had not obtained either the interim construction loan or the furniture and fixtures loan at the stated fixed interest rates, but rather at interest rates that floated ing rate. The land lease was for fifteen years with a fifteen-year renewal option instead of forty years with renewal and purchase options. Loftsgaarden knowingly underestimated the construction time by five months, thus the memorandum's estimate that construction loan interest would amount to $130,000 was too low because it was based on a lower interest rate and a shorter construction time than actually expected. It was also not true that he had a firm commitment from Larwin for tthe partnership's permanent financing. The loan was contingent upon Larwin receiving adequate assurance that it was not usurious under Minnesota law.[12] Overall, the budgets and fore-

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[10]At a nine and one-half percent interest rate.

[11]These findings and conclusions relate to the district court's ruling on plaintiffs' §12(2) claim and are consistent with the special verdict returned by the jury upon the §10(b), Rule 10b-5, Ch. 80A. and common law fraud claims. D.R. 266-74.

[12]At the time the offering memorandum was circulated, Minnesota law limited interest rates on loans to noncorporations to eight percent. Larwin finally agreed to make the loan through a corporate nominee, PDRC, which borrowed the money at nine and one-half percent from Larwin and then advanced it to the partnership at the legal rate of eight percent. PDRC recovered its loss on the transaction by adjusting the land rent it charged to the partnership. *Supra* note 7.

casts in the offering memorandum were found to be based on unreasonable and misleading assumptions.

Additionally, it was found that Loftsgaarden had omitted any explanation of the role his closely-held corporation would assume in the development. He did not reveal that PDRC expected to earn a profit on the various land transactions required to set up the sale-leaseback arrangement, that PDRC would receive a commitment fee for having obtained financing for the partnership, and that he owned a thirty percent interest in ARC-TEC—the architectural firm with which he contracted to design the motel. Overall, it was clear that Loftsgaarden and the corporate defendants expected compensation considerably greater than the $103,000 stated in the offering memorandum, their expectation being more on the order of $240,000.

Alotel Associates encountered financial difficulties from the project's inception. Construction costs exceeded those budgeted, largely because of ever-increasing interests rates.[15] When the motel finally opened in June 1974, operating expenses exceeded those that were forecast and occupancy rates fell short of expected levels. Exacerbating matters was Larwin's refusal to "take out" (*supra* note 5) the interim construction loan upon completion of construction because it had not received adequate assurances that its loan to the partnership was legal under the Minnesota usury law. Loftsgaarden was not able to placate Larwin and get the permanent financing in place until De-

[15]The district court's findings indicate that the prime rate charged by the construction lender, First National Bank of St. Paul, rose from six percent in February 1973 to ten percent in February 1974. As has already been noted, the partnership was obliged to pay interest on this $2.31 million loan at a floating rate of four percent over the bank's prime lending rate.

cember 1974, resulting in an additional six months of high interest charges to the partnership. Loftsgaarden sold five additional units in Associates in October 1974 to raise $175,000 for repayment of debts and additional operating capital. In February 1975 Loftsgaarden asked the limited partners to make $125,000 in loans to keep Associates afloat. The limited partners hired an accountant, John Essene, to investigate the partnership's financial condition. Essene reported in March that in fact $200,000 would probably be required to continue business operations. Plaintiffs and other limited partners did make loans to Associates at this point,[14] but they also hired an attorney to make further investigation of the partnership's financial affairs. The district court found that by August or September 1975, plaintiffs knew or should have known of defendants' fraud. In September, Loftsgaarden agreed to resign as general partner; thereafter plaintiffs made additional loans to Associates, but the business continued to flounder. Associates ultimately defaulted on its loans and land rent payments and foreclosure by creditors ensued.

Plaintiffs filed their complaint on February 24, 1976. On June 25, 1980, after a seven-day trial, the jury found that Loftsgaarden knowingly had made material misrepresentations and omissions in the offering memorandum upon which plaintiffs relied and which caused plaintiffs' damages, thus satisfying all the elements of the § 10 (b), Rule 10b-5, Ch. 80A, and common law fraud claims.[15] The district court also accepted the jury's advisory verdict that Loftsgaarden was liable under § 12(2) because

[14]The jury found that neither these nor any subsequent advances were induced by any misrepresentations by Loftsgaarden and plaintiffs were not entitled to recover any of the amounts advanced.

[15]The parties agree that the elements of these various claims are identical.

he knowingly made material misrepresentations or omissions of which plaintiffs were unaware, and because there was some causal connection between Loftsgaarden's wrongful conduct and plaintiffs' purchases.[16] *See Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977).

II.

Loftsgaarden complains that there is insufficient evidence of materiality, reliance or causation to sustain the jury's verdict upon plaintiffs' § 10 (b), Rule 10b-5, Ch. 80A. and common law fraud claims. It is also claimed that the district court's findings of materiality and causation in support of its conclusion that liability existed under §12 (2) are clearly erroneous.

A.

A statement or omitted fact is considered material if it is substantially likely that a reasonable investor would consider the matter important in making an investment decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).[17] Whether or not the misrepresented or omitted fact is important turns on whether a reasonable investor would regard it as significantly altering the total mix of information made available. *Id.*

Leaving aside the relatively few misrepresented and omitted matters which Loftsgaarden claims are unsupported by the evidence, we focus upon what we regard as

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[16]Reliance is not an element of an action under §12(2). *Alton Box Board Co. v. Goldman, Sachs & Co* 560 F.2d 916, 924 (8th Cir. 1977).

[17]*TSC Industries* arose under §14(a) of the Securities Exchange Act of 1934, but the test for materiality is the same under all of the securities statutes. *See Alton Box Board Co. v. Goldman, Sachs & Co., supra* at 919-20.

his primary challenge to the materiality finding Loftsgaarden in effect admits that the following facts were either misrepresented in or omitted from the offering memorandum, but he argues that these facts should be deemed immaterial: Loftsgaarden held a 30% interest in ARC-TEC; the partnership was to pay a $25,000 brokerage fee in conjunction with the sale of land; the project was a revision of a prior failed offering by Loftsgaarden; Crawford was an unlicensed seller; the interest rate on the interim construction loan floated at four percent over the prime rate; the land lease was for a shorter term than represented; the furniture and fixtures loan was to be secured by a chattel mortgage; the permanent financing from Larwin was contingent upon assurances that it would not be usurious; the corporate general partner was an unfunded shell corporation; Loftsgaarden stood to gain over twice the profits stated; and the offering, while not required to be registered with the state, would have failed to qualify had registration been sought.

The jury applied the proper standard of materiality and found that full disclosure of the above matters would be regarded as important by a reasonable investor. The Supreme Court has recognized that the trier of fact is uniquely competent to make the materiality determination, requiring as it does "delicate assessments of inferences a [reasonable investor] would draw from a given set of facts . . . ." *Id.* at 450. We cannot fault the jury's assessments in this case and we uphold the materiality finding.

B.

Ordinarily, reliance requires proof that the misrepresentations actually induced plaintiffs to act differently than

they otherwise would have in making their investment decisions. *St. Louis U. Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978). But in cases involving primarily a failure to disclose, reliance will be presumed upon a showing that the withheld information was material. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). Because there were both misrepresentations and omissions in the offering memorandum, Loftsgaarden requested and the jury given a dual instruction which stated that plaintiffs had the burden of proving they relied on the misrepresentations, but that as to the omissions, reliance was presumed upon a showing of the materiality of the omitted facts.[18]

Loftsgaarden contends that there is no evidence to support a finding of reliance in this case. On the contrary, the record indicates that the only information received by plaintiffs came from the offering memorandum. Austin testified that he went over the offering memorandum with Crawford, devoting particular attention to the forecast

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[18]The court instructed:

> In this case, the plaintiffs allege that the offering memorandum which was supplied to them by defendant Loftsgaarden contained representations which were false and misleading. They also alleged that defendant Loftsgaarden made oral representations to them at the time that they purchased their units in Alotel Associates, and at the time that further contributions to the partnership were solicited, which were false and misleading. As stated above, before the plaintiffs can prevail on these claims, they must first prove that such false and misleading representations were made. In addition, the plaintiffs must prove that they in fact relied upon these representations.
>
> The plaintiffs also claim that the offering memorandum was false and misleading in that it failed to disclose material facts. Where the claims asserted under Section 10(b) or Rule 10b-5 relate to nondisclosure as opposed to misrepresentations, then, if the nondisclosed facts are material, there is a presumption that the plaintiffs relied upon that nondisclosure. In that case, the plaintiffs need not prove that they would have acted differently had the facts been disclosed.

T. 795-96.

of cash flow, and that the memorandum "was the principal reason, I would say, that I invested in it." T. 557. Likewise, Anderson testified that he read and made notes on the offering memorandum and that it was "the extent of the information I did have at the time I invested." (T. 591. Randall relied on the advice of his accountant, John Essene, who testified, "All I had to work with was the offering circular. . . . It was really the only source of information that was available." T. 494. Neumann relied on the advice of his accountant and business partner, Delroy Blaske, who reviewed and analyzed the offering memorandum, particularly focusing on the forecasts. Blaske testified the offering memorandum was "all we had to go on." T. 568.[19]

Loftsgaarden argues that there is no evidence plaintiffs actually were misled by any of the specific aspects of the offering memorandum that were found to have been misrepresented. But misrepresentations so permeated this document that the trial court found their cumulative effect was to render the forecasts and projections unreasonable and misleading.[20] Accordingly, reliance could be found

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[19]Loftsgaarden argues that no "derivative reliance" theory (i.e., plaintiffs relied on experts who in turn relied on the offering memorandum) may be advanced because such a theory was neither pled nor raised at trial. *See Kiernan v. Homeland, Inc.*, 611 F.2d 785, 789-90 (9th Cir. 1980). We reject this argument. The so-called derivative reliance theory was disallowed in *Keirnan* because plaintiff raised it for the first time on appeal, effectively denying defendants any opportunity for rebuttal. In addition, plaintiff failed to introduce any evidence that the third parties upon whom he purportedly relied did themselves rely on any misrepresentations. In the instant case, the third parties upon whom Neuman and Randall relied. Blaske and Essene, gave direct testimony and were subject to cross-examination on the reliance issue.

[20]*Cf. Nye v. Blyth Eastman Dillon & Co.*, 588 F.2d 1189, 1197 n.14 (8th Cir. 1978) ("The appellants attempt to separate out each misrepresentation and show that each was insufficient to mislead the appellees. Such a position has little merit. Considered in the aggregate, we agree with the trial court that the misrepresentations did induce reliance on the part of the appellees.").

from evidence that plaintiffs' only source of information in making their investment decisions was the offering memorandum.

It is next argued that the trial court erred in failing to instruct that the presumption of reliance upon material omitted facts is rebuttable. This point would be more troublesome were we confronted with a situation where the only reliance instruction given was a presumption instruction. In such a case, we think it is necessary that defendant be allowed to rebut the presumption of reliance and that the jury be instructed on the rebuttable nature of this presumption. *See Sharp v. Coopers & Lybrand,* 649 F.2d 175, 189 (3d Cir. 1981); *cert. denied,* 50 U.S.L.W. 3668 (U.S. February 23, 1982) (No. 81-433); *Shores v. Sklar,* 647 F.2d 462, 476 (5th Cir. 1981), *petition for cert. filed,* 50 U.S.L.W. 3377 (U.S. November 2, 1981) (No. 81-839); *St. Louis U. Trust Co., supra* at 1049. But we hold that Loftsgaarden suffered no prejudice in the instant case by the omission of the rebuttability instruction because, independent of any presumption of reliance that may have been made, the jury found that plaintiffs affirmatively proved reliance.[21]

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[21]It is not apparent from the findings on the §10(b) and Rule 10b-5 claims whether the jury found affirmative proof of reliance upon misrepresentations or presumed reliance based on material omissions or both. The issue, however, is clarified by the jury's alternative finding of liability based upon common law fraud. In this regard, the trial court instructed that plaintiffs had the burden of affirmatively proving reliance in order to recover.

Overall, the instructions and special verdict questions fully and correctly presented the reliance issue to the jury. We are, however, inclined to agree with the Third Circuit that a dual instruciton on reliance is not the appropriate solution when confronted with a securities fraud case where both misrepresentations and omissions are present. We endorse that circuit's conclusion that "the proper approach to the problem of reliance is to analyze the plaintiff's allegations, in light of the likely proof at trial, and determine the most reasonable placement of the burden of proof of reliance." *Sharp v. Coopers & Lybrand,* 649 F.2d 175, 188 (3d Cir. 1981). Such an approach is consistent with this circuit's view that the presumption of reliance is limited to cases involving primarily omissions. *Vervaecke v. Chiles, Heider & Co.,* 578 F.2d 713, 716-17 (8th Cir. 1978).

C.

Causation requires a showing of "some causal nexus between the defendant's wrongful conduct and [plaintiff's] loss." *St. Louis U. Trust Co., supra* at 1048. Loftsgaarden contends that there is no connection between the misrepresentations and omissions in the offering memorandum and the eventual foreclosure of the motel.[22] The theory advanced appears to be something akin to a contributory negligence defense, in which Loftsgaarden claims that it was acts by plaintiffs themselves that caused foreclosure of the motel. Our answer to this is simply that any direct contribution made by plaintiffs to the demise of the project after they ousted Loftsgaarden as general partner does not relieve him from liability for his own intentional tortious acts. The evidence shows that the numerous misrepresentations and omissions—particularly those relating to financing—unquestionably caused the project to be launched on unsound financial footing. This in itself is sufficient evidence to establish causation. Loftsgaarden is not to be excused from liability because of plaintiffs' inability to extract themselves from a predicament for which he was squarely to blame.

D.

Thus, we uphold the finding of liability on § 10 (b), Rule 10b-5, Ch. 80A. and common law fraud. On the

[22]He further contends that the trial court erred in precluding introduction of evidence surrounding the progress of the project and the decisions which led to its ultimate foreclosure after Loftsgaarden resigned as general partner. We have examined the record and we hold that the evidentiary matters raised by Loftsgaarden had no bearing on the causation issue and were properly excluded for the reasons stated by the lower court at trial.

basis of the foregoing discussion, we also hold that no clear error exists in the lower court's findings of materiality and causation in support of its conclusion that liability exists under § 12 (2). As previously stated, the materiality standard is the same under all the securities statutes. *Alton Box Board Co. v. Goldman, Sachs & Co., supra* at 919-20. Causation under § 12 (2) is shown by demonstrating "some causal relationship" between the misrepresentations or omissions and plaintiffs' purchases. *Id.* at 924. We are nowhere left with the "definite and firm conviction that a mistake has been committed" regarding either of these findings. *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948).

In addition, we reject Loftsgaarden's argument that rescission under § 12(2) was not an available remedy to plaintiffs because no timely demand for rescission nor timely tender of the limited partnership units was made. We do not read § 12(2) as requiring any demand for rescission. All that is required is that the claim be made within the applicable statute of limitations, § 13 of the 1933 Act, 15 U.S.C. § 77m Section 13 requires that action brought under § 12(2) must be brought within one year after the untrue statement or the omission is discovered or should have been discovered and that in no event may an action be brought more than three years after the sale. But even an untimely claim raised under § 12(2) may survive if it is raised in accordance with the relation back rule. Rule 15 (c), F.R.Civ.P.; *see Gridley v. Cunningham*, 550 F.2d 551, 553-54 (8th Cir. 1977); *Gannett Co. v. Register Pub. Co.*, 428 F.Supp. 818, 823 (D. Conn. 1977); *Wassel v. Eglowsky*, 399 F.Supp. 1330, 1358-59 (D. Md. 1975), *aff'd*, 542 F.2d 1235 (4th Cir. 1976); *cf. Straley v.*

Universal Uranium and Milling Corp., 289 F.2d 370, 372-73 (9th Cir. 1961) (relation back of amendment stating claim under § 12 (1)).

It is undisputed that plaintiffs' original complaint, filed on February 26, 1976, was timely. The complaint alleged violations of § 10 (b), Rule 10b-5, and Minnesota securities law. The § 12 (2) claim was raised in subsequent amendments to the complaint filed on December 26, 1978, and May 18, 1979. It is also undisputed that the § 12 (2) claim "arose out of the conduct, transaction, or occurrence set forth . . . in the original pleading." Rule 15 (c), F.C.Civ.P. Accordingly, the § 12(2) claim was timely raised because the amendments related back to the date of the original pleading. *Id. See generally* C. Wright & A. Miller, *Federal Practice and Procedure* § 1497 at 499-500 (1971).

Nor are we persuaded that plaintiffs' claim under § 12 (2) should be barred because no tender of the limited partnership units was made until shortly before trial. No time for tender is prescribed by § 12(2) and this circuit has held that a tender prior to or during trial satisfies the requirement. *Gridley v. Cunningham, supra* at 554; *see also Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1034-35 (2d Cir. 1979).

III.

Before addressing damages, we briefly consider and reject two tangential points raised by Loftsgaarden. One point concerns an allegedly prejudicial remark made by the court to Loftsgaarden's counsel. At the end of the first day of trial, the court limited counsel's cross-examination of Crawford to an amount of time equal to that consumed

by plaintiffs in their direct examination. When counsel for Loftsgaarden balked, the court stated, "I don't want to be critical but you spent 15 minutes on minor historical meetings." T. 143. The following day, Loftsgaarden moved for a mistrial alleging the court's comment constituted judicial misconduct, irreparably prejudicing the rights of the defendants. It is claimed the lower court erred in denying the motion. We cannot say that such an incidental remark in any way reflected any conscious or unconscious desire on the part of the trial court to deprive Loftsgaarden of a fair trial. *Cf. Agee v. Lofton*, 287 F.2d 709, 710 (8th Cir. 1961) ("[The trial judge's] remarks making light of the plaintiffs and their witnesses were, in our opinion, calculated to prevent the plaintiffs from having the sort of trial to which they were legally entitled."). Furthermore, any possible prejudice was cured by the court in its instructions to the jury.[22]

The second point raised is that the lower court abused its discretion in permitting plaintiffs to introduce evidence of a prior fraud committed by Loftsgaarden. After Loftsgaarden denied any intent to defraud plaintiffs, the court permitted plaintiffs to rebut this testimony by introducing evidence of a 1976 state court determination that Loftsgaarden had defrauded a party in a real estate transaction. The lower court concluded that the evidence was probative of intent and that its value in this regard outweighed any prejudice. *See* Fed.R.Evid. 403. A limiting instruction

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[22]The jury was told:

> It is the duty of the Court to admonish an attorney who, out of zeal for his cause, does something which is not in keeping with the rules of evidence or procedure. You are to draw no inference against the side to whom an admonition of the Court may have been addressed during the trial of the case.

T. 782.

was given in which it was made clear that the evidence "was received only as it may relate to [Loftsgaarden's] intent and for no other purpose." Once Loftsgaarden denied any intent to defraud, it was within the trial court's discretion to permit evidence of the prior fraud. *See Fed.* R.Evid. 404 (b). We hold that the court did not abuse its discretion in allowing this evidence to be placed before the jury.

IV.

The most hotly contested issue in this case concerns the district court"s ruling that Loftsgaarden could not introduce any evidence about the tax benefits accruing to plaintiffs as a result of their participation in Alotel Associates. Loftsgaarden argues that the evidence was crucial to the issue of whether plaintiffs, regardless of whether they had been defrauded, suffered any actual damages.

A.

"[D]amages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party. . . ." *Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63, 69 (8th Cir. 1980), *cert. denied*, 449 U.S. 1079 (1981); *cf.* 15 U.S.C. § 78bb (a) (limiting plaintiff's recovery under the 1934 Act to "actual damages on account of the act complained of"). Failure by the complaining party to prove actual damages is fatal to the party's claim. *Shapiro, supra* at 70. Generally, the out-of-pocket measure of damages is applied in securities fraud cases, usually awarding plaintiff (in the case of a defrauded purchaser) the difference between the purchase price of the security

and its actual value on the date of purchase.[24] *Harris v. American Investment Co.*, 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976). This measure, however, is "not a talisman"; the function of the court "is to fashion the remedy best suited to the harm." *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978). Accordingly, a rescissional remedy, *id.*, or some other measure of damages in the nature of restitution may be applied. *Cf. Myzel v. Fields*, 386 F.2d 718, 742-43 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) ("Rescission calls for cancellation of the bargain, and the return of the parties to the *status quo ante;* . . . [b]ut where there exists no market value of the stock, the stock is no longer in existence, and there clearly has been a fluctuation in value . . ., then what restitutional damages are to be awarded must depend upon the facts of the particular case.").

The actual damages principle requires that a rescissional or restitutional award be "reduced by any value received as a result of the fraudulent transaction." *Garnatz v. Stifel, Nicolaus & Co., supra* at 1361. This principle applies in the instant case not only to the § 10 (b) and Rule 10b-5 claims, but also to the claims under * 12(2) and Minnesota law. Under § 12(2), the defendant guilty of prospectus fraud shall be liable to plaintiff,

> who may sue either at law or in equity in any court of competent jurisdiction, to recover the considera-

[24]Where fraud is found to have affected the open market price of the security because others were influenced by the same misrepresentations made to the person seeking recovery, the measure applied is the difference between the purchase price and the actual value on the date of discovery of the fraud. *Harris v. American Investment Co.*, 523 F.2d 220, 226 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976).

> tion paid for such security with interest thereon, *less the amount of any income received thereon,* upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77*l* (emphasis added). Similarly, the Supreme Court of Minnesota holds that the defrauded party is entitled to no recovery unless plaintiff is able to prove that he suffered actual damages as a result. *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980); *cf.* Minn. Stat. § 80A.23 (limiting recovery to actual damages sustained for violation of state securities laws).

At trial Loftsgaarden attempted to show that in spite of any fraud he may have perpetrated, plaintiffs suffered no actual damages because of the tangible economic benefit they derived from the limited partnership units in the form of large tax write-offs which they used to offset their sizeable professional incomes. Loftsgaarden's offer of proof indicates that he was prepared to introduce evidence that three of the four plaintiffs suffered no actual damages on account of the tax savings they experienced from the investment. The district court stated that it was "not going to get into a lot of complicated tax testimony" (T. 23), and disallowed the evidence, dismissing the argument as "sophistic malarky." D.R. 438. The court concluded that the limited partnership units were worthless and instructed the jury that if they found liability, the measure of damages would be the amount "which the plaintiffs paid out in reliance upon the false representations of [the] defendant . . ." T. 805. We take no issue with the court's decision to apply what was essentially a rescissory

measure of damages in this case,[23] but we hold that the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs.

V.

We have already explained the basic principles of real estate tax shelter investment in Part I of this opinion. The aim is to generate large amounts of artificial losses in the early years of the investment which may be passed on to the limited partners for use in offsetting their outside income. The ultimate goal, of course, is to establish a positive cash flow and become an income-producing enterprise, which income—just as the early losses—is distributed proportionately to the limited partners. Thus the benefits from a profitable real estate tax shelter investment are two-fold, offering tax savings to the limited partner in its early years and generating income in later years. But unlike a corporate shareholder, for example, even if the enterprise fails to become profitable, the limited partner clearly may have something of value because of the investment's unique tax treatment:

> A limited partner who has been misled into investing in an unprofitable real estate venture may be in a better position than a shareholder in an unprofitable

[23] Accordingly, there is no merit to Loftsgaarden's contention that the lower court erred in failing to submit to the jury the issue of when plaintiffs discovered the fraud. Loftsgaarden contends that jury determination of the question was "crucial to the issue of damages." Brief at 38. But in the context of damages, the time of discovery of the fraud is crucial only where the out-of-pocket measure is to be applied and the trier of fact is obliged to value the security as of this date.

> corporation. By use of depreciation, real estate limited partnerships can generate a substantial tax loss while actually taking in sufficient cash to cover partnership expenses. This tax loss can be passed through to the partners as a shelter for other taxable income. In the extreme case where the partnership's gross rents are exactly equal to its expenditures, the tax loss continues to make the partnership an attractive investment. On the other hand, the stock of a corporation having no profit or prospects of profit would be worthless, and a shareholder in that corporation would value any recovery in a civil suit more than his investment.

Note, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 Va.L.Rev. 669, 672-73 (1977) (footnotes omitted). We note that the above excerpt discusses the value of the limited partnership interest in a break-even investment. Whether or not the costs exceeded the benefits in the instant case where the enterprise never even reached the break-even point cannot be determined absent evidence on the matter.

The few recent cases addressing the issue hold that in private securities fraud actions brought by limited partners in real estate tax shelter investments, consideration of tax benefits received by the limited partners is relevant to the question of whether plaintiffs suffered any actual damage. In *Bridgen v. Scott*, 456 F.Supp. 1048 (S.D. Tex. 1978), limited partners sued the general partner under § 10 (b) and Rule 10b-5 after they received tax benefits, but no profit upon a speculative real estate investment.

The court permitted defendant to introduce evidence of the tax aspects of the investment:

> Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial "never-never land." The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.

Id. at 1061. The court held that application of a rescissory damage measure would require reduction of the price paid by the specific value received by plaintiffs in the form of tax write-offs. *Id.* at 1060. In *Smith v. Bader*, 83 F.R.D. 437 (S.D.N.Y. 1979), the court permitted discovery of plaintiffs' tax returns, holding that "knowledge of plaintiffs' income tax rate and the net value of their investment, along with other information, may be needed to calculate any tax benefits which may mitigate damages'" *Id.* at 439. Similarly, in *Berg v. Xerxes-Southdale Office Bldg. Co supra*, at 615, the court held that in valuing the interest in a real estate limited partnership, income tax considerations are relevant. *Cf. Dupuy v. Dupuy*, 551 F.2d 1005, 1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Bayoud v. Ballard*, 404 F.Supp. 417, 426 (N.D. Tex. 1975); *Hickman v. Groesbeck*, 389 F.Supp. 769, 779-80 (D. Utah 1974). Indeed, the tax aspects of a real estate limited partnership investment are of such tangible economic benefit to the investor that damages are recoverable under the securities laws where, on account of fraud by the offeror, tax write-offs taken by the investor are disallowed by the

Internal Revenue Service. *Sharp v. Coopers & Lybrand, supra.* Thus, we acknowledge the value of the tax deductions generated by such an investment and hold that the strictly compensatory nature of damages awardable in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs.

The lower court's allusion to the complexity of evidence relating to plaintiffs' tax savings is not a viable reason for precluding such evidence in light of *Norfolk & Western R. Co. v. Liepelt,* 444 U.S. 490 (1980). In the context of a wrongful death action under the Federal Employer's Liability Act (FELA),[26] the Court held that it was error to preclude evidence of the income tax payable on the decedent's past and estimated future earnings and to refuse to instruct the jury that the award of damages would not be subject to income taxation. While admitting that many variables affect the amount of a wage earner's future income tax liability, the Court observed that the calculation was no more uncertain or complex than that already made by juries in determining future earnings. The Court concluded, "We therefore reject the notion that the introduction of evidence describing a decedent's estimated after-tax earnings is too speculative or complex for a jury." *Id.* at 494.

In the case before us, it is likely that the jury will not even be faced with the vagaries of calculating future income tax liability. Loftsgaarden's offer of proof indicated that he was prepared to show, based on an analysis of plaintiffs' income tax returns for the years 1973 to 1978, that three out of the four plaintiffs were net dollars ahead

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[26] 45 U.S.C. §51 *et seq.*

after foreclosure of the investment. All plaintiffs except Dr. Randall reported the proceeds from the foreclosure in their 1978 tax returns.[27] Thus, the net affect of the investment is subject to proof without the need for the jury to speculate about the impact of any future recoupment of the losses deducted. This is not to say that the present damage calculation is entirely devoid of speculation. Plaintiffs did indicate that their returns for the years 1973 to 1978 were undergoing audits by the Internal Revenue Service. Evidence of the audit and expert opinions as to its likely results are admissible at the retrial on damages. Certainly the possibility that past tax deductions will be disallowed is relevant to the determination of the extent of any benefit actually received by plaintiffs from those deductions. The jury is entitled to determine whether and to what extent there would be a disallowance of deductions.

We wish to clarify that the impact of our holding is not nearly so far-reaching as plaintiffs predict. They argue that because there are tax consequences to any investment one makes, evidence of those consequences will not figure in every securities fraud case. But our holding applies only to cases involving investments that are expressly marketed and sold as tax shelters. That is, investments which allow the investor

> to offset certain "artificial losses" (that is, noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from those investments but also against

[27]It is safe to assume that by this time, Dr. Randall has also reported the extent of his proportional share of the proceeds from the foreclosure. Even if he has not so reported, the extent of his share certainly is either known or discoverable.

> the [investor's] other income, usually from his regular business or professional activity.

Staff of Joint Comm. on Internal Revenue Taxation, 94th Cong., 1st Sess., *Overview of Tax Shelters* 1 (Comm. Print 1975).

In conclusion we hold that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

V.

For the foregoing reasons, we vacate the award of damages and remand to the district court for a new trial on that issue.[28] In all other respects, the judgment of the district court is affirmed.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.

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[28] Accordingly, it is unnecessary for us now to address issues raised regarding the awards of prejudgment interest and attorneys' fees.

APPENDIX E

Dr. Roger E. Austin, Dr. Thomas W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,

Plaintiffs,

vs.

B. J. Loftsgaarden, M. S. Noah, Lyman H. Coult, Alotel Inc., a Minnesota corporation, Property Development & Research Co., a Minnesota corporation, and 2361 Building Corp., a Minnesota corporation,

Defendants.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER FOR JUDGMENT

No. 4-76- Civ. 82

INTRODUCTION

This securities fraud case proceeded to trial and the jury found for the plaintiffs on the 10b-5, Minn. Stat. § 80A.23 and common law fraud claims. The § 12(2) count was to be decided by the Court and was submitted to the jury for an advisory verdict. The jury also found for the plaintiffs on this count. The Court accepts the jury's verdict and adopts the propposed findings of fact and conclusions of law submitted by plaintiffs, as modified below.

FINDINGS OF FACT

1. Defendants B. J. Loftsgaarden ("Loftsgaarden") and Alotel Incorporated offered to sell and did sell limited partnership units in Alotel Associates, a Minnesota limited

partnership, to plaintiffs Dr. Roger E. Austin ("Austin"), Dr. Thomas W. Anderson ("Anderson"), Dr. Myrel A. Neumann ("Neumann"), and Dr. William C. Randall ("Randall"). The offers were made and the sales were accomplished by means of a document which was denominated "Offering Memorandum."

2. The Offering Memorandum included the following statements.

(a) The Offering Memorandum stated that it was then presently contemplated that interim construction financing would be obtained from the First National Bank of St. Paul at an interest rate of 9-1/2% per annum.

(b) The Offering Memorandum stated that projected construction loan interest would be $130,000.

(c) The Offering Memorandum stated that the land on which the motel project was to be built had been leased for an initial term of 40 years with renewal options extending thereafter.

(d) The Offering Memorandum stated that it was anticipated that construction of the project would begin in May of 1973, that construction would be completed by December of 1973 and that the motel might be opened for occupancy in December of 1973.

(e) The Offering Memorandum stated that it was then contemplated that Alotel Associates would enter into a construction contract for the construction and furnishing of the motel for a total expenditure of $3,150,000 (including certain expenditures which were to be treated as partnership expenses for tax purposes).

(f) The Offering Memorandum stated that it was

then projected that the developer and the construction company would receive a total of $103,900 for "overhead and profit."

(g) The Offering Memorandum stated that it assumed that a $240,000 five-year 8% loan would be obtained in January of 1974.

(h) The Offering Memorandum stated that Alotel Associates had procured a firm commitment for long-term financing of the project from Larwin Realty & Mortgage Trust ("Larwin").

(i) The Offering Memorandum included various budgets and forecasts.

3. The following facts were known to Loftsgaarden and Alotel Incorporated:

(a) On February 15, 1973, Loftsgaarden filed an application with First National Bank of St. Paul for interim construction financing for Defendant Property Development & Research Company ("PDRC"). The rate of interest to be charged pursuant to that commitment was one which would float at 4% per annum over the prime rate charged by First National Bank of St. Paul. Subsequently First National Bank of St. Paul issued a commitment on the terms stated. Between December 27, 1972, and February 25, 1973, the prime rate charged by First National Bank of St. Paul was 6%. Between February 26, 1973, and March 18, 1973, the prime rate was 6-1/4%. Between March 19, 1973, and May 6, 1973, the prime rate was 6-3/4% .Between May 7, 1973 and May 24, 1973, the prime rate was 7%. Between May 25, 1973, and June 6, 1973, the prime rate was 7-1/4%. Between June 7, 1973, and June

20, 1973, the prime rate was 7-1/2%. Between June 21, 1973, and July 1, 1973, the prime rate was 7-3/4%. Between July 2, 1973, and July 5, 1973, the prime rate was 8%. Between July 6, 1973, and July 17, 1973, the prime rate was 8-1/4%. Between July 18, 1973, and July 26, 1973, the prime rate was 8-1/2%. Between July 27, 1973, and August 5, 1973, the prime rate was 8-3/4%. Between August 6, 1973, and August 12, 1973, the prime rate was 9%. Between August 13, 1973, and August 19, 1973, the prime rate was 9-1/4%. Between August 20, 1973 and August 26, 1973, the prime rate was 9-1/2%. Between August 27, 1973 and September 13, 1973 the prime rate was 9-3/4%. Between September 14, 1973, and February 6, 1974, the prime rate was 10%.

(b) The projected construction loan interest depended upon the prime rate's remaining at 9-1/2% per year and completion of the construction of the motel on December 31, 1973. Construction of the motel began in June of 1973. Loftsgaarden and Alotel Incorporated anticipated that it would require at least one (1) year to complete construction of the motel.

(c) Alotel Associates was never a party to a lease for an initial term of forty (40) years with renewal options. On October 24, 1973, Alotel Associates became a party to a lease with an initial term of fifteen (15) years with a fifteen-year renewal option. That lease contained no option to purchase.

(d) Loftsgaarden and Alotel Incorporated never caused Alotel Associates to execute a contract for the construction and furnishing of the motel for a total expenditure of $3.150,000 (including certain expendi-

tures which were to be treated as partnership expenses for tax purposes) and did not contemplate that they would cause Alotel Associates to enter into such a construction contract.

(e) Loftsgaarden submitted construction estimates to First National Bank of St.Paul and Larwin Realty and Mortgage Trust ("Larwin") in which he stated that he, PDRC or Defendant 2361 Building Corporation ("2361") expected that "overhead" would total $61,668 and that "contingency and profit" would total $254,900.

(f) On July 31, 1973, Loftsgaarden had obtained a commitment for a five-year $240,000 loan. The commitment provided that the interest rate would float at up to 3% over the prime rate.

(g) Alotel Associates would not be able to make use of the commitment from Larwin because of conditions contained in the commitment.

4. The statements set forth in Paragraph 2 were untrue and were statements of material fact.

5. The Offering Memorandum omitted to state the following facts:

(a) It was contemplated that interim construction financing would be obtained from First National Bank of St. Paul at an interest rate which would float at 4% over the prime rate charged by First National Bank of St. Paul and that the prime rate would continue to exceed 5-1/2% per annum.

(b) Projected construction loan interest was dependent upon the prime rates remaining at 5-1/2% per annum and the completion of construction of the motel project on December 31, 1973.

(c) Construction of the motel project had begun in June of 1973.

(d) Projected construction loan interest was dependent upon the completion of construction of the motel in seven (7) months. Loftsgaarden, Alotel Incorporated, PDRC and 2361 expected that construction of the motel would require at least one year.

(e) The $240,000 five-year loan was to be secured by a chattel mortgage of the furniture, fixtures, and some of the equipment of the motel.

(f) The $240,000 five-year loan was to be obtained at a rate of interest which would float at up to 3% per annum over the prime rate charged by the First National Bank of Rochester.

(g) Larwin's commitment for long-term financing of the project was dependent upon Larwin's obtaining of a satisfactory opinion from a Minnesota attorney of its choice that the loan to Alotel Associates would not be usurious.

(h) The risk that the loan from Larwin to Alotel Associations would be found to be usurious was so substantial that Larwin would be able either to refuse to honor its commitment or to insist upon certain conditions which would impose substantial additional costs and risks upon Alotel Associates.

(i) Loftsgaarden had not and would not fund Alotel Incorporated and did not intend that Alotel Incorporated would ever become either an active or a financially responsible general partner of Alotel Associates.

(j) Loftsgaarden did not state that certain of the persons whom the Offering Memorandum had identified

as directors and officers of Alotel Incorporated had not agreed to become active directors and officers.

(k) Loftsgaarden was the sole shareholder of PDRC.

(l) PDRC held options to purchase or the fee interest in most of the tracts of land upon which the motel was to be constructed.

(m) Loftsgaarden, Alotel Incorporated and PDRC intended and expected that PDRC would earn a substantial profit through PDRC's acquisition and sale of the land upon which the motel was to be constructed.

(n) Loftsgaarden owned 30% of the outstanding shares of stock of arc-TECH, inc., the corporation which was to act as the architect in connection with the design and construction of the motel project and which was to earn a fee of $90,000.

(o) Loftsgaarden, Alotel Incorporated, PDRC and 2361 intended and expected that they would receive compensation which would be considerably in excess of the "overhead and profit" which was projected in the Offering Memorandum.

(p) Loftsgaarden, Alotel Incorporated and PDRC intended and expected that PDRC would be paid a commitment fee by Alotel Associates for obtaining financing for the motel project.

(q) Paul D. Crawford ("Crawford"), a person who was purporting to act as an investment advisor to Austin, Anderson and Neumann in connection with Loftsgaarden's and Alotel Incorporated's offers to sell and sales of limited partnership units in Alotel Associates, was not licensed to act as an investment advisor. Crawford, whom Loftsgaarden had caused 2361 to

hire and whom Loftsgaarden had caused to offer to sell and to sell a limited partnership in Alotel Associates to Randall, had had his license to sell securities suspended by the Commissioner of Securities of the State of Minnesota.

(r) The budgets and forecasts contained in the Offering Memorandum were based upon assumptions and a rational that were not reasonable and were misleading in light of the facts known to Loftsgaarden, Alotel Incorporated, PDRC and 2361.

6. The omitted facts set forth in Paragraph 5 were material facts.

7. The omitted facts set forth in Paragraph 5 were material facts.

8. Loftsgaarden's and Alotel Incorporated's offers and sales of limited partnership units in Alotel Associates to Anderson, Austin, Neumann and Randall were made and accomplished by the use of means and instruments of transportation and communication in interstate commerce and of the mails.

9. At the time that Anderson purchased his limited partnership unit in Alotel Associates, he did not know of the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

10. At the time that Austin purchased his limited partnership unit in Alotel Associates, he did not know of the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

11. At the time that Neumann purchased his limited partnership units in Alotel Associates, he did not know of

the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

12. At the time that Randall purchased his limited partnership unit in Alotel Associates, he did not know of the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

13. Loftsgaarden and Alotel Incorporated have not sustained the burden of proof that they did not know and in the exercise of reasonable care could not have known of the untrue statements and omissions set forth in Paragraph 2 and 5 because of the following:

(a) At the time that the Offering Memorandum was prepared and at the time of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that the interim construction financing would be obtained only at a rate which would float at 4% per annum over the prime rate charged by First National Bank of St. Paul.

(b) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that the total projected construction loan interest of $130,000 depended upon the prime rates remaining at 5-1/2% per year and the completion of construction of the motel on December 31, 1973, that the prime rate had risen above 5-1/2% per annum and that construction of the motel would require at least one year and would not be completed until long after December 31, 1973.

(c) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson,

Austin, Neumann and Randall, Loftsgaarden knew that Alotel Associates had not executed a 40-year lease with renewal options extending thereafter with respect to the land on which the motel was to be constructed.

(d) On October 24, 1973, Loftsgaarden knew that Alotel Associates had executed a 15-year lease with a 15-year renewal option.

(e) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that construction of the motel was expected to take at least one year.

(f) In June 1973 and thereafter, Loftsgaarden knew that the $240,000 five-year loan would be obtained at an interest rate which would float above the prime rate, that the interest rate might be as much 3% per annum above the prime rate and that the loan would be secured by a chattel mortgage of the furniture, fixtures and certain of the equipment at the motel.

(g) In June 1973 and thereafter, Loftsgaarden knew that Larwin would not make long term financing available directly to Alotel Associates because charging Alotel Associates interest at 9-1/2% per annum would be usurious under Minnesota law and that Larwin would make such a loan only through a nominee.

(h) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he would not cause 2361, the general contractor, to enter into a contract with Alotel Associates for the construction and furnishing of the motel for total expenditure of $3,150,000 (including certain expenditures

which would be treated as partnership expenses for tax purposes).

(i) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he had not caused and did not intend to cause Alotel Incorporated to be funded and that he did not intend Alotel Incorporated ever to become an active or financially responsible general partner of Alotel Associates.

(j) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he expected that he and/or PDRC expected to earn a profit through the acquisition and sale of the land upon which the motel was to be constructed.

(k) At the time the Offering Memorandum was prepared and at the time of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he owned 30% of the outstanding stock of arc-PECH, inc., that arc-TECH, inc., was to be the architect involved in designing and supervising construction of the motel and that arc-Tech, inc., would earn a fee of $90,000.

(l) At the time that the Offering Memorandum was prepared, Loftsgaarden knew that he intended that either he or his companies expected to receive compensation and profits in excesss of $240,000 as a result of the development of the motel for Alotel Associates.

(m) Loftsgaarden knew that Alotel Associates would pay PDRC a commmitment fee for obtaining long-term financing for the motel project.

(n) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that Crawford was not licensed to act as an investment advisor. In October 1973, Loftsgaarden knew that the Commissioner of Securities of the State of Minnesota had suspended Crawford's license to sell securities.

(o) At the time the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that the budgets and forecasts contained in the Offering Memorandum were based upon assumptions and a rationale that were not reasonable and which were misleading in light of the facts known to him.

14. At all relevant times, Loftsgaarden was the president, a director, the sole shareholder and a controlling person of Alotel Incorporated, PDRC and 2361.

15. Anderson, Austin, Neumann and Randall relied upon the Offering Memorandum, including the untrue statements contained therein, in making their purchases of limited partnership units in Alotel Associates. Such reliance was either direct, indirect through an advisor who directly relied upon the Offering Memorandum or a combination of both.

16. There was a causal relationship between the Offering Memorandum's inclusion of the untrue statements set forth in Paragraph 2 and omission of the facts set forth in Paragraph 5 and Anderson's, Austin's, Neumann's and Randall's purchases of limited partnership units in Alotel Associates.

17. There was no causal connection between the defendants' fraud and plaintiffs' loans to the partnership.

18. Dr. Anderson purchased one limited partnership unit of Alotel Associates on June 2, 1973, for $35,000. Dr. Austin purchased one unit on June 26, 1973, for $35,000. Dr. Neumann purchased one unit on August 21, 1973, for $35,000. He purchased one-half unit on October 19, 1973, for $17,500. Dr. Randall purchased one unit on November 23, 1973 for $35,000.

19. In March 1975, Anderson, Austin, Neumann, Randall and the other investors in Alotel Associates retained John Essene, a certified public accountant, in an effort to obtain accurate financial information concerning Alotel Associates.

20. In July 1975, Anderson, Austin, Neumann, Randall and the other investors in Alotel Associates retained Gene Happe, an attorney, to investigate the financial affairs of Alotel Associates.

21. Retention of John Essene and Gene Happe followed Anderson's, Austin's, Neumann's and Randall's first suspicions that there was something amiss concerning the financial affairs of Alotel Associates and constituted the exercise of reasonable diligence to discover the untrue statements set forth in Paragraph 2 and the omissions set forth in Paragraph 5.

22. Plaintiffs discovered or should have discovered defendants' fraud some time in August-September 1975. The original complaint in this action was filed on February 24, 1976.

23. At the time that Anderson, Austin, Neumann and Randall discovered that the Offering Memorandum contained untrue statements of material fact and omitted to state material facts, the limited partnership units in Alotel Associates which they had purchased were valueless.

24. Anderson, Austin, Neumann and Randall have tendered the limited partnership units in Alotel Associates which they had purchased to Loftsgaarden and Alotel Incorporated.

CONCLUSIONS OF LAW

1. The Court has subject matter jurisdiction over this action.

2. The limited partnership units of Alotel Associates purchased by the plaintiffs were securities.

3. B. J. Loftsgaarden and Alotel Incorporated offered or sold a security by the use of means or instruments of transportation or communication in interstate commerce or of the mails; by means of a prospectus or oral communication, which included an untrue statement of a material fact and omitted to state a material fact necessary in order to make the statements not misleading. This conduct is a violation of 15 U.S.C. § 77*l* (2).

4. None of the plaintiffs knew at the time of such offer or such sale of the untruths or omissions.

5. B. J. Loftsgaarden and Alotel Incorporated knew or in the exercise of reasonable care should have known of such untruths or omissions.

6. Although reliance is not a necessary element of a § 12(2) action, plaintiffs did rely on the defendants' untrue statements.

7. Although reliance is not an element of the § 12(2) action, there must be a showing of some causal connection between the defendants' wrongful conduct and the plaintiffs' purchases. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225 (7th Cir. 1980); *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 924 (8th Cir. 1977);

Eriksson v. Galvin, 484 F.Supp. 1108, 1121 (S.D .N.Y. 1980). Plaintiffs have established this connection in regard to their purchases of the limited partnership units, but did not establish the requisite connection in regard to their loans to the partnership.

8. Plaintiffs brought this action within one year after the discovery of the untrue statements or the omissions or within one year after such discovery should have been made by the exercise of reasonable diligence. The plaintiffs also commenced this action within three years after the date of the sale of the limited partnership units to them. The Court was persuaded by the evidence produced at trial that the plaintiffs could have discovered the fraud in August-September of 1975. Even if some of defendants' arguments were accepted, the earliest discovery date would be about March of 1975. This action would still have been timely since the complaint was filed in February 1976.

9. It is generally an equitable requirement of rescission that a tender of the security be made to the defendants. Plaintiffs here did not make such a tender until shortly before trial. Such a tender could be appropriate under any circumstances. *See Gridley v. Cunningham*, 550 F.2d 551, 554 (8th Cir. 1977). By the time the plaintiffs here had learned of the fraud, their securities were worthless and a tender was essentially futile. There was no showing that defendants would have repurchased the units at that time. Under these circumstances it is impossible to restore the status quo by tender, and plaintiffs are not barred from recovery merely because they did not tender until shortly before trial. *See Wigand v. Flo-Tek*, 609 F.2d 1028, 1035 (2d Cir. 1979).

10. Pursuant to section 12(2) of the Securities Act of

1933, plaintiffs are entitled to recover the consideration paid for the limited partnership units.

11. Plaintiffs are also entitled to prejudgment interest in the amounts set forth in the Court's post-trial Order on the other counts.

ORDER FOR JUDGMENT

IT IS ORDERED THAT:

1. Judgment is entered for the same plaintiffs and against the same defendants on the § 12 (2) count in accordance with the Judgment entered on June 25, 1980, and the Memorandum Order entered August 15, 1980.

2. The Court has found defendants liable to plaintiffs on the § 12(2) claim. The jury found defendants liable on the 10b-5, Minnesota Statutes § 80A.23 and common law fraud claims. Any of these counts independently supports defendants' liability; but each plaintiff is entitled only to a single recovery. In addition, as further explained in today's post-trial Order on the jury verdict, only the § 12 (2) and Minnesota Statutes § 80A.23 count supports the award of prejudgment interest; and only the Minnesota Statutes § 80A.23 count supports the award of attorneys' fees.

August 15, 1980.

/s/ Earl R. Larson
United States Senior District Judge

APPENDIX F

(Title of Cause.)

MEMORANDUM ORDER
No. 4-76-riv. 82

The plaintiffs here were investors in a limited partnership. They sued the seller of the partnership units for securities and common law fraud. After trial, the jury returned verdicts in favor of plaintiffs on the 10b-5, Minn. Stat. § 80A.23 and common law fraud claims. Both plaintiffs and defendants have made a number of post-trial motions.

DEFENDANTS' MOTION FOR A NEW TRIAL OR JUDGMENT NOTWITHSTANDING THE VERDICT

Defendants contend that there was insufficient evidence to support the jury's findings of materiality, reliance or causation. Although defendants' brief refers only to the 10b-5 claim, the argument is apparently also addressed to the State securities law and common law fraud claims.

The materiality requirement serves two functions. It protects sellers and buyers of securities from having to disclose every picayune fact which might be related to the transaction. It also has an important role in the determination of causation, particularly in nondisclosure or omission cases. A misrepresentation or omitted fact is material if there is a substantial likelihood that a reasonable purchaser would consider it important or would give it actual significance in making his investment decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U S. 438. 449 (1976). The reliance requirement encompasses whether the particular

plaintiff did consider the misrepresentation or omission important or significant, or whether he would have made the same decision even if he had known the full truth. The only purpose of this element is to aid in ensuring the presence of causation. Causation involves a determination that the misrepresentation or nondisclosure by the defendant led to the plaintiff's loss.

When a misrepresentation is the basis for a plaintiff's claim, he must show reliance. The Eighth Circuit has held that this rule applies to misstatements and half-truths, which have the same essential nature as misrepresentations.[1] *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 (8th Cir. 1978). A different rule, however, has long been followed when the defendant's wrongful conduct consists of a failure to disclose a material fact. In this circumstance, because plaintiffs can hardly be expected to prove actual reliance on what does not exist; a presumption of reliance arises.[2] *Affiliated Ute Citizens v. United*

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[1]Defendants argue that there are not true omissions in this case, and therefore the *Vervaecke* rule applies. Defendants have mischaracterized the nature of this case and the *Vervaecke* holding. There were omissions here aside from any misstatements or half-truths. *Vervaecke* is not a model of clarity, but if its holding were as defendants claim, it would conflict with *Affiliated Ute*, and well-reasoned decisions in other circuits. The whole question of omissions is largely irrelevant because the jury found reliance on the affirmative misrepresentations and that, coupled with the finding of causation, is sufficient to justify the defendants' liability.

[2]The presumption of reliance has also been found in circumstances where the defendants' fraud depresses secondary market value. *See Shores v. Sklar*, 610 F.2d 235, 239 (5th Cir. 1980). In addition, *Shores v. Sklar* eliminated the need for reliance where the fraud was a major cause for the security being sold at all. 610 F.2d at 240. That reasoning could properly be extended to this case. A first attempted offering failed miserably. The second offering, reworked and replete with misrepresentations and omissions, succeeded in attracting investors. Unless it did attract a certain number of purchasers, by its own terms the offering would not result in formation of a limited partnership. Therefore, the reliance of the various investors could be viewed as interwoven. Case law seems to recognize that where causation is clearly established, reliance becomes largely irrelevant. That situation may be present here.

States, 406 U.S. 128, 153 (1972); *Continental Grain, Ltd. v. Pacific Oilseeds, Inc.*, 582 F.2d 409, 412 n.1 (8th Cir. 1979). The fairness of this rule stems from the fact that the defendant has created the problem by failing to disclose the material fact.[3] Of course, defendants may introduce evidence to rebut this presumption. *Shores v. Sklar*, 610 F.2d 235, 239 (5th Cir. 1980); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1049 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

When an affirmative misrepresentation is alleged, causation is proved by showing that the plaintiff relied on the misrepresentation and that the misrepresentation is related to plaintiff's loss. In the case of a nondisclosure, causation may be established merely by proving the materiality of the omitted fact, which creates the presumption of reliance.[4] *Affiliated Ute Citizens v. United States*, 406 U.S. at 154; *Stromfield v. Great Atlantic & Pacific Tea Co.*, 484 F.Supp. 1264, 1270 (S.D. N.Y. 1980); *Eriksson v. Galvin*, 484 F.Supp. 1108, 1126 (S.D.N.Y. 1080). These rules should not be applied rigidly, but must always be used to analyze a particular set of facts with an awareness of the linkage between these concepts.

Some courts attempt to split causation into "loss causation" and "transaction causation." This distinction ap-

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[3]The linkage between materiality and reliance also supports this rule. Reliance on an immaterial fact is highly unlikely. The odds are, however, that an investor will rely on any material facts in making his investment decision.

[4]It is unclear why courts do not mention the need for some further proof of causation in omission cases. Perhaps it is believed that once materialitty is shown and reliance presumed. it is highly likely that causation is also present. In any event, defendants can always introduce evidence designed to undercut the causal connection between the fraud and loss.

pears to be based on confusion over whether a plaintiff should have to show that the alleged fraud was directly related to the security's drop in value (loss causation) or whether it is enough to show that the fraud induced purchase of the security (transaction causation). It might be argued that even when a defendant's fraud causes purchase of a security, it is unfair to find him liable when the loss is caused by factors unrelated to the fraud. The opposing argument is that any time fraud induces purchase, causation-in-fact or but-for causation of a resulting loss has been established.

It appears to the Court that the appropriate focus is on loss causation. *See Vervaecke v. Chiles, Heider & Co.*, 578 F.2d at 715. The essence of securities fraud *damage* actions is whether plaintiff suffered a loss because of the defendant's conduct, not whether he purchased a security because of it.[5] It also seems reasonable, however, to presume that a drop in value is caused by the fraud. *See Seiffer v. Topsy's International, Inc.*, 487 F.Supp. 643, 665-66 (D. Kan. 1980). Therefore, generally even if only transaction causation were established, plaintiff would have met his burden of proof on the causation issue; and any time loss causation is shown, even if transaction causation is not, that burden is met. *See Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S 951 (1978). In this case there was sufficient evidence to sustain findings of both transaction and loss causation, and there is no basis for overturning the jury's conclusion that defendants' fraud led to plaintiffs' damages.

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[5]Of course, the fraud must be "in connection with" a sale or purchase for plaintiff to have standing. This is analytically different, however, from the determination whether the fraud induced the sale or purchase.

The law in the fraud area is not always crystal clear. The important thing is that the jury get an adequate statement of the law. The Court believes that its instructions were correct and fulfilled their purpose. Counsel were given wide latitude in arguing their theories of the case. The jury was attentive and apparently had a good grasp of the law and facts. Materiality, reliance and causation involve factual and objective determinations and are properly given to the jury for decision. No adequate reason has been presented to the Court for overturning the jury's findings. Not only was there ample affirmative evidence offered by plaintiffs to support the verdict, but defendant Loftsgaarden's evasive and resistive testimony could have seriously undermined the credibility of his version of the facts in the jury's eyes. Certainly the Court has no feeling that an injustice has been done to the defendants.

Defendants next raise a large group of interconnected arguments centering around the measure of damages and the tax benefits plaintiffs received on their investments. They claim that plaintiffs suffered no damage because of these tax benefits, that the Court used the wrong measure of damages, that the Court should have allowed the jury to decide when the fraud was discovered for damages purposes, that reference to tax benefits should not have been excised from some exhibits and that the Court should have received more evidence on subsequent events for the purpose of showing that plaintiffs' damages were their own fault. The Court finds no merit in any of these alleged errors.

Initially, the Court would note that defendants overstress the tax aspect of these investments. The offering memorandum contained projections which estimated large tax losses only in the first two years of the hotel's operation.

After two more years of small losses, the limited partners would have received significant yearly income on which tax would have to be paid. Each limited partner would have ended up with a large amount of tax owing, not including any tax on money received if and when the hotel was sold. In addition, the offering memorandum warned of impending changes in the tax laws which would limit the tax losses. Furthermore, plaintiffs were not actually going to make any money because of tax losses; what they were getting was a tax deferral. The limited partners clearly were interested in making money. The projections displayed a business which would provide them with good yearly income as well as gain at time of disposal. They were upset when they discovered that the project was becoming insolvent, and they took several steps to try to put the partnership on a profitable track, including loaning money and replacing the general partner. This suit is further evidence that plaintiffs do not feel they got their money's worth from some incidental tax benefits.

The Court did allow defendants to introduce evidence of the tax benefits to show that any misrepresentation on another subject was not material to the investors. The jury apparently rejected this argument and adopted the common sense view that people do not make an investment for losses, tax or otherwise, but because they anticipate a profit.

The Court totally rejects defendants' suggestion that because plaintiffs received some tax benefits they have not been damaged. Plaintiffs expended at least $35,000 each for a security which became worthless. The causes of the failure of the partnership business were linked to defendants' fraud. Plaintiffs have shown damage.

The subsequent events evidence which defendants sought to introduce, and the Court rejected, supposedly went to the merits of the counterclaim which was dismissed. Defendants did not represent at that time that it was being offered for any other purpose. Evidence was received from both sides on the ultimate fate of the hotel property. Any further evidence would have been repetitious and time consuming.

Damages in a 10b-5 action are intended to be compensatory. *Shapiro v. Midwest Rubber Reclaiming Co.*, No. 79-1424, slip op. at 10 (8th Cir. July 25, 1980); *Harris v. American Investment Co.*, 523 F.2d 220, 225 n.4 (8th Cir. 1975) *cert. denied*, 423 U.S. 1054 (1976). Generally, an "out-of-pocket" measure is used, *Harris v. American Investment Co.*, 523 F.2d at 225, but this is not a rigid rule and the Court must choose a measure of damages which will compensate plaintiffs. *See Nye v. Blythe Eastman Dillon & Co.*, 588 F.2d 1189, 1198 (8th Cir. 1978); *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d at 1360. A rescissionary measure may be appropriate, particularly with securities that are worthless or have no objective standards by which they may be valued. *Garnatz v. Stifel, Nicolaus & Co., supra.*

In this case, however, an out-of-pocket or a rescissionary measure would yield the same results. The out-of-pocket formulation is usually the difference in value between purchase date and the time the fraud is discovered. *Shapiro v. Midwest Rubber Reclaiming Co., supra; Harris v. American Investment Co.*, 523 F.2d at 226. The fraud was or should have been discovered in August-September 1975. Defendants offered no reliable evidence to show that the date of discovery was any earlier. By this time the

partnership was essentially insolvent and the securities worthless. In fact, the securities had been worthless since early 1975. There was never any secondary market in which these units had value. Plaintiffs represented that they were purchasing their interests solely for investment, and the limited partnership agreement placed heavy restrictions on the resale of the units. Under these circumstances, the Court felt that if fraud had been committed, the only proper compensatory measure of damages was the refund of plaintiffs' purchase price. Even if this ruling were wrong as to the fraud claims, the Court's decision today that § 12(2) provides an alternative basis for defendants' liability supports the rescissionary measure of damages.

Defendants most vociferous argument is that plaintiffs' damages should have been offset by tax benefits received. This is sophistic malarkey. The best answer to defendants' contentions is found in decisions by well respected Federal courts. *Cooper v. Hallgarten & Co.*, 34 F.R.D. 482, 485-86 (S.D. N.Y. 1964). The court addressed the issue by saying:

> "The fact that the revenue laws permitted plaintiff to make deductions . . . has no bearing on the issue of whether plaintiff is entitled to receive the return of the amounts he paid. . . . If plaintiff should recover the sums he paid, they no doubt would be subject to appropriate tax treatment in his tax return as against the deductions and depletions and allowances taken in the earlier years."

The court in *Wiesenberger v. W. E. Hutton & Co.*, 35 F.R. 556, 558 (S.D. N.Y. 1964), stated that this argument was without merit. The court added that personal injury cases, where *loss of earnings* is at issue, should be distinguished.

Finally, the court noted that it was illogical to reduce damages for extraneous reasons wholly unconnected with defendant's wrongful conduct. Our own district court has rejected defendants' arguments in *Rhode v. Hershberger Explorations,* 349 F.Supp. 993, 994 (D. Minn. 1972). Judge Neville found the argument "fallacious," "circuitous" and "obviously without merit." The court stated that:

> "To the extent recovery is had, amended income tax returns will have to be filed to counteract the loss in the year deducted or in some way the recovery included in a current tax return as ordinary income."

See also Sharp v. Coopers & Lybrand, 83 F.R.D. 343 (E.D. Pa. 1979).

These decisions provide ample grounds for ignoring defendants' claims. *Bridgen v. Scott,* 456 F.Supp. 1048 (S.D. Tex. 1978), seems to be a case where the court's reasoning was tailored in an attempt to fit what it felt was a just result. There are also important factual distinctions, such as the fact that the investors were not to get a yearly income stream from the project.

Plaintiffs have lost the purchase price of their investment. They may have received some temporary tax savings. In the absence of defendants' fraud, they would ultimately have had significant income and tax costs. Plaintiffs, however, cannot recover the projected future income which they never received because the fraud measure of damages is strictly compensatory. Defendants' argument is a sort of reverse expectancy measure of damages and must be likewise rejected. Absent defendants' fraud, which induced their purchases, plaintiffs would probably have made other

investments which provided temporary tax savings, but without the total loss of their investment.

Defendants allege that the Court erred in instructing the jury that the limited partnership interests were securities. It is well settled that such interests are securities. *See Goodman v. Epstein,* 582 F.2d 388, 409 (7th Cir. 1978), *cert. denied,* 440 U.S. 939 (1979). Defendants argue that whether or not the interests were securities should be judged at a time after the purchase of the interests; and that plaintiffs' conduct in this case was sufficient to deprive the limited partnership interests of their status as securities. Whether or not a particular investment is a security must be decided as of the date of sale. Securities fraud laws are designed to prevent wrongdoing in connection with the *purchase or sale* of securities. It is patently unfair to deprive investors of the protection of the securities laws at the time they purchased the security merely because their subsequent conduct might change the classification of their investment. Such subsequent conduct might be a factor in determining whether a defendant's fraud caused plaintiff's loss, but it does not affect the nature of the investment at the time it was sold.

Defendants do not even attempt to argue that these limited partnerships were not securities when purchased. It is absolutely clear that plaintiffs, as limited partnership law requires, were to have no part in the day-to-day management of the partnership. Furthermore, the actions of the limited partners did not remove their investments from security status. They had the right to replace the general partner. They had the right to be concerned about what was happening to their investment, and to seek information to satisfy themselves that it was being properly

run. There was absolutely no evidence which showed that any limited partner, and, in particular, these plaintiffs, ever made any decisions relating to the daily management of the partnership business.

The Court allegedly erred in admitting evidence about a prior fraud committed by Loftsgaarden. He was found liable in 1976 of defrauding a person in connection with a real estate investment. Defendants argue that this could have nothing to do with his state of mind in 1973 when the plaintiffs' limited partnership units were sold. Defendants conveniently ignore the fact that although the verdict was returned against Loftsgaarden in 1976, the underlying circumstances of the fraud occurred before the sale of the limited partnership units at issue here. The evidence was probative of his intent, and the Court concluded that any prejudice caused by the evidence was outweighed by its usefulness. *See McCormick on Evidence* § 164.

Defendants again raise the issue of a prior settlement in another suit which supposedly bars this action. The Court has dealt with this claim in other orders and has nothing to add to those discussions. Defendants also claim that on the first day of trial the Court made certain prejudicial comments which required a mistrial. There is no substance to this claim either.

The parties had a fair trial before a competent jury. They were represented by able counsel. Another trial would not produce a substantially different result.

PLAINTIFFS' MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

Plaintiffs have moved for judgment notwithstanding the verdict against defendants Coult and Noah, who were di-

rectors of Alotel, Inc. Their liability would be based on "controlling person" and "aider and abettor" theories. The jury rejected these theories. The Court believes the jury's finding was proper. There was no evidence to show that these defendants had any awareness of any wrongdoing, or more than a minimal involvement in the entire hotel project. Neither defendant took any active part in or had any control over the management of Alotel, Inc. In fact, they appeared to have merely allowed their names to be used to fill the statutory quota of directors as a favor to Loftsgaarden. Even if the Minnesota law is broader than Federal law, the Court does not believe it would be just or correct under that law to impose liability on these defendants.

Plaintiffs also have moved for judgment NOV on the loans which the limited partners made to the partnership beginning in the spring of 1975. The jury found against plaintiffs on these loans, apparently because there was no reliance on any misrepresentations at the time the loans were made. The Court believes there was evidence to support the jury's findings, and that the jury's decision was correct. First of all, the loans probably cannot be viewed as securities or as a new investment decision based on prior purchase of a security. There was no clause in the limited partnership agreement requiring the limited partners to make additional capital contributions or loans. *Cf. Goodman v. Epstein*, 582 F.2d 388, 391 n 8, 414 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979). The loans may or may not be securities themselves; the Court feels they are not. Whether they are or not, there was evidence from which the jury could have inferred that there was no reliance on any fraud by defendants when plaintiffs made the

loans. Even if there were additional omissions, on which reliance would not have to be shown, plaintiffs would still have to establish causation. There was clear and ample evidence from which the jury could have found that plaintiffs made the additional loans because they were advised that if they did not do so, the whole venture would go bankrupt, and that defendants' fraud had no role in the decisions to make the loans to the partnership. The Court today has also found that the § 12(2) claims do not provide a basis for liability on the loans because no causal relation existed between defendants' fraud and the extension of the loans.

PLAINTIFFS' MOTION FOR PREJUDGMENT INTEREST AND COSTS

Plaintiffs have requested that the judgment be amended to include prejudgment interest. If the 10b-5 claims were the only source of defendants' liability, the Court would deny this request. *See Nelson v. Hench,* 428 F.Supp. 411, 421 (D. Minn. 1977). In a separate opinion issued today, however, the Court has accepted the jury's advisory verdict on the § 12(2) claim. That section, 15 U.S.C. § 77*l* (2), allows prejudgment interest. Plaintiffs contend that 28 U.S.C. § 1261 requires that the Court look to State law to find the applicable rate of interest. They say that rate is provided by Minn. Stat. § 549.09. Neither of those statutes applies to prejudgment interest. The Court believes that the traditional 8% interest rate is a fair rate to apply here.

In addition, Minn. Stat. § 80A.23 subd. 2, which the jury also found to be a basis for plaintiffs' recovery, allows prejudgment interest. Not all of the plaintiffs, however, could claim the benefit of this provision, because it had

an August 1, 1973, effective date. If the § 12(2) finding is reversed, only plaintiff Randall and plaintiff Neumann would be entitled to prejudgment interest.

Plaintiffs have also requested an award of costs. The figure presented by plaintiffs appear to be reasonable and this amount will be granted.

PLAINTIFFS' MOTION FOR ATTORNEYS' FEES

Plaintiffs have moved the Court to allow the recovery of attorneys' fees. The Federal securities law claims do not support the granting of attorneys' fees. Minn. Stat. § 80.23 does allow attorneys' fees, but, as noted above, this section is not applicable to all the plaintiffs' claim. A transitional section to the new securities law provided that the old law, which did not allow attorneys' fees, would govern cases "initiated on the basis of facts or circumstances occurring before August 1, 1973 " Plaintiffs Austin and Anderson purchased their interests in the limited partnership before August 1, 1973. The facts and circumstances which form the basis of their claims would be the alleged fraud which took place when they were sold these interests. These misstatements and omissions occurred before the applicable date of the new securities law. Only plaintiffs Randall and Neumann can recover their attorneys' fees.

Randall's attorneys submitted an affidavit totaling about $31,000 in fees, without multiplier. The Court does not believe this would be a reasonable fee to award. No division of time was made between fees for the Minnesota law claims and the Federal claims. The elements of the two are similar, but there are also distinctions. The Court questions whether it was necessary for Randall to be rep-

resented by two attorneys at trial. Much of the work was probably duplicated by the other plaintiffs' attorneys. While each plaintiff is entitled to his own counsel, it is not fair to saddle a defendant with the excessive fees generated by this arrangement. A reasonable fee for Randall's attorneys is $10,000.

Neumann shared attorneys with Austin and Anderson. They had an agreement whereby each would pay one third of the total billing. It is likely, however, that most of the work done by these plaintiffs' attorneys would have been done even if Neumann had been the only client. The problems presented by the fee requested by Randall's attorneys are a factor here also. Neumann's attorney, however, did most of the trial work. A fee of about $34,000 was requested. It appears to the Court that a reasonable fee would be $15,000.

Therefore, IT IS ORDERED THAT:

1. Defendants' motions for Judgment Notwithstanding the Verdict or a New Trial are denied.

2. Plaintiffs' motion for Judgment Notwithstanding the Verdict is denied.

3. Plaintiffs' motions for prejudgment interest are granted in the following amounts, computed at 8% per annum from the date of purchase:

Plaintiff Randall:	$18,924.59
Plaintiff Anderson:	20,175.25
Plaintiff Austin:	19,991.17
Plaintiff Neumann's ½ unit	9,556.66
Plaintiff Neumann's one unit	19,553.53

4. Plaintiffs' motions for costs are granted in the following amounts:

Plaintiff Randall	$1,308.62
Plaintiffs Anderson, Austin and Neumann:	2,210.53

5. Plaintiffs Randall and Neumann's motions for an award of attorneys' fees are granted as follows:

Plaintiff Randall:	$10,000.00
Plaintiff Neumann:	15,000.00

Plaintiffs Austin and Anderson's motions for attorneys' fees are denied.

August 15, 1980.

/s/ Earl R. Larson
United States Senior District Judge

APPENDIX G

STATUTES AND REGULATION

Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2):

> Any person who —
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> * * *
>
> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national security exchange —

> (b) To use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.

Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a):

> The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of the actual damages on account of the act complained of.